Test ID: 32025185

Question #1 of 60

Question ID: 609989

Questions 1-6 relate to Glenda Garvey.

Glenda Garvey is interning at Samson Financial in the summer to earn money for her last semester of MBA studies. She took the Level III CFA® exam in June but has not yet received her results. Garvey's work involves preparing research reports on small companies.

Garvey is at lunch with a group of co-workers. She listens to their conversation about various stocks and takes note of a comment from Tony Topel, a veteran analyst. Topel is talking about Vallo Engineering, a small stock he has tried repeatedly to convince the investment director to add to the monitored list. While the investment director does not like Vallo, Topel has faith in the company and has gradually accumulated 5,000 shares for his own account. Another analyst, Mary Kennedy, tells the group about Koral Koatings, a paint and sealant manufacturer. Kennedy has spent most of the last week at the office doing research on Koral. She has concluded that the stock is undervalued and consensus earnings estimates are conservative. However, she has not filed a report for Samson, nor does she intend to. She said she has purchased the stock for herself and advises her colleagues to do the same. After she gets back to the office, Garvey purchases 25 shares of Vallo and 50 shares of Koral for herself.

Samson pays its interns very little, and Garvey works as a waitress at a diner in the financial district to supplement her income. The dinner crowd includes many analysts and brokers who work at nearby businesses. While waiting tables that night, Garvey hears two employees of a major brokerage house discussing Metrona, a nanotechnology company. The restaurant patrons say that the broker's star analyst has issued a report with a buy rating on Metrona that morning. The diners plan to buy the stock the next morning. After Garvey finishes her shift, restaurant manager Mandy Jones, a longtime Samson client, asks to speak with her. Jones commends Garvey for her hard work at the restaurant, praising her punctuality and positive attitude, and offers her two tickets to a Yankees game as a bonus.

The next morning, Garvey buys 40 shares of Metrona for her own account at the market open. Soon afterward, she receives a call from Harold Koons, one of Samson's largest money-management clients. Koons says he got Garvey's name from Bertha Witt, who manages the Koons's account. Koons wanted to reward the analyst who discovered Anvil Hammers, a machine-tool company whose stock soared soon after it was added to his portfolio. Garvey prepared the original report on Anvil Hammers. Koons offers Garvey two free round-trip tickets to the city of her choice. Garvey thanks Koons, then asks her immediate supervisor, Karl May, about the gift from Koons but does not mention the gift from Jones. May approves the Koons' gift.

After talking with May, Garvey starts a research project on Zenith Enterprises, a frozen-juice maker. Garvey's gathers quarterly data on the company's sales and profits over the past two years. Garvey uses a simple linear regression to estimate the relationship between GDP growth and Zenith's sales growth. Next she uses a consensus GDP estimate from a well-known economic data reporting service and her regression model to extrapolate growth rates for the next three years.

Garvey is not working at the diner that night, so she goes home to work on her biography for an online placement service. In it she makes the following two statements:

Statement 1: I'm a Level III CFA candidate, and I expect to receive my charter this fall. The CFA program is a grueling, 3-part,

graduate-level course, and passage requires an expertise in a variety of financial instruments, as well as knowledge of the forces that drive our economy and financial markets.

Statement 2: I expect to graduate with my MBA from Braxton College at the end of the fall semester. As both an MBA and a CFA, I'll be in high demand. Hire me now while you still have the chance.

Akshay Nagoree, CFA, is a portfolio manager for several pension funds at Samson. His wife is treasurer and 15% shareholder of Gatedon Electric. The market value of Mrs. Nagoree's Gatedon shares is now $2 million. Samson's research department is recommending the stock to its trust officers and pension fund portfolio managers. Samson has adopted CFA Institute's Research Objectivity Standards.

.....

During the lunch conversation, which CFA Institute Standard of Professional Conduct was *most likely* violated?

A) III(B) Fair Dealing.

B) IV(A) Loyalty.

C) V(A) Reasonable Basis.

Question #2 of 60

Question ID: 609990

Glenda Garvey is interning at Samson Financial in the summer to earn money for her last semester of MBA studies. She took the Level III CFA® exam in June but has not yet received her results. Garvey's work involves preparing research reports on small companies.

Garvey is at lunch with a group of co-workers. She listens to their conversation about various stocks and takes note of a comment from Tony Topel, a veteran analyst. Topel is talking about Vallo Engineering, a small stock he has tried repeatedly to convince the investment director to add to the monitored list. While the investment director does not like Vallo, Topel has faith in the company and has gradually accumulated 5,000 shares for his own account. Another analyst, Mary Kennedy, tells the group about Koral Koatings, a paint and sealant manufacturer. Kennedy has spent most of the last week at the office doing research on Koral. She has concluded that the stock is undervalued and consensus earnings estimates are conservative. However, she has not filed a report for Samson, nor does she intend to. She said she has purchased the stock for herself and advises her colleagues to do the same. After she gets back to the office, Garvey purchases 25 shares of Vallo and 50 shares of Koral for herself.

Samson pays its interns very little, and Garvey works as a waitress at a diner in the financial district to supplement her income. The dinner crowd includes many analysts and brokers who work at nearby businesses. While waiting tables that night, Garvey hears two employees of a major brokerage house discussing Metrona, a nanotechnology company. The restaurant patrons say that the broker's star analyst has issued a report with a buy rating on Metrona that morning. The diners plan to buy the stock the next morning. After Garvey finishes her shift, restaurant manager Mandy Jones, a longtime Samson client, asks to speak with her. Jones commends Garvey for her hard work at the restaurant, praising her punctuality and positive attitude, and offers her two tickets to a Yankees game as a bonus.

The next morning, Garvey buys 40 shares of Metrona for her own account at the market open. Soon afterward, she receives a

call from Harold Koons, one of Samson's largest money-management clients. Koons says he got Garvey's name from Bertha Witt, who manages the Koons's account. Koons wanted to reward the analyst who discovered Anvil Hammers, a machine-tool company whose stock soared soon after it was added to his portfolio. Garvey prepared the original report on Anvil Hammers. Koons offers Garvey two free round-trip tickets to the city of her choice. Garvey thanks Koons, then asks her immediate supervisor, Karl May, about the gift from Koons but does not mention the gift from Jones. May approves the Koons' gift.

After talking with May, Garvey starts a research project on Zenith Enterprises, a frozen-juice maker. Garvey's gathers quarterly data on the company's sales and profits over the past two years. Garvey uses a simple linear regression to estimate the relationship between GDP growth and Zenith's sales growth. Next she uses a consensus GDP estimate from a well-known economic data reporting service and her regression model to extrapolate growth rates for the next three years.

Garvey is not working at the diner that night, so she goes home to work on her biography for an online placement service. In it she makes the following two statements:

Statement 1:	I'm a Level III CFA candidate, and I expect to receive my charter this fall. The CFA program is a grueling, 3-part, graduate-level course, and passage requires an expertise in a variety of financial instruments, as well as knowledge of the forces that drive our economy and financial markets.
Statement 2:	I expect to graduate with my MBA from Braxton College at the end of the fall semester. As both an MBA and a CFA, I'll be in high demand. Hire me now while you still have the chance.

Akshay Nagoree, CFA, is a portfolio manager for several pension funds at Samson. His wife is treasurer and 15% shareholder of Gatedon Electric. The market value of Mrs. Nagoree's Gatedon shares is now $2 million. Samson's research department is recommending the stock to its trust officers and pension fund portfolio managers. Samson has adopted CFA Institute's Research Objectivity Standards.

.....

Does Garvey's acceptance of the gifts from Koons and Jones violate Standard I(B) Independence and Objectivity?

A) Accepting Koons' gift was a violation.

B) Accepting Jones' gift was a violation.

C) Neither gift would result in a violation.

Question #3 of 60

Question ID: 609991

Glenda Garvey is interning at Samson Financial in the summer to earn money for her last semester of MBA studies. She took the Level III CFA® exam in June but has not yet received her results. Garvey's work involves preparing research reports on small companies.

Garvey is at lunch with a group of co-workers. She listens to their conversation about various stocks and takes note of a comment from Tony Topel, a veteran analyst. Topel is talking about Vallo Engineering, a small stock he has tried repeatedly to convince the investment director to add to the monitored list. While the investment director does not like Vallo, Topel has faith in the company and has gradually accumulated 5,000 shares for his own account. Another analyst, Mary Kennedy, tells the

group about Koral Koatings, a paint and sealant manufacturer. Kennedy has spent most of the last week at the office doing research on Koral. She has concluded that the stock is undervalued and consensus earnings estimates are conservative. However, she has not filed a report for Samson, nor does she intend to. She said she has purchased the stock for herself and advises her colleagues to do the same. After she gets back to the office, Garvey purchases 25 shares of Vallo and 50 shares of Koral for herself.

Samson pays its interns very little, and Garvey works as a waitress at a diner in the financial district to supplement her income. The dinner crowd includes many analysts and brokers who work at nearby businesses. While waiting tables that night, Garvey hears two employees of a major brokerage house discussing Metrona, a nanotechnology company. The restaurant patrons say that the broker's star analyst has issued a report with a buy rating on Metrona that morning. The diners plan to buy the stock the next morning. After Garvey finishes her shift, restaurant manager Mandy Jones, a longtime Samson client, asks to speak with her. Jones commends Garvey for her hard work at the restaurant, praising her punctuality and positive attitude, and offers her two tickets to a Yankees game as a bonus.

The next morning, Garvey buys 40 shares of Metrona for her own account at the market open. Soon afterward, she receives a call from Harold Koons, one of Samson's largest money-management clients. Koons says he got Garvey's name from Bertha Witt, who manages the Koons's account. Koons wanted to reward the analyst who discovered Anvil Hammers, a machine-tool company whose stock soared soon after it was added to his portfolio. Garvey prepared the original report on Anvil Hammers. Koons offers Garvey two free round-trip tickets to the city of her choice. Garvey thanks Koons, then asks her immediate supervisor, Karl May, about the gift from Koons but does not mention the gift from Jones. May approves the Koons' gift.

After talking with May, Garvey starts a research project on Zenith Enterprises, a frozen-juice maker. Garvey's gathers quarterly data on the company's sales and profits over the past two years. Garvey uses a simple linear regression to estimate the relationship between GDP growth and Zenith's sales growth. Next she uses a consensus GDP estimate from a well-known economic data reporting service and her regression model to extrapolate growth rates for the next three years.

Garvey is not working at the diner that night, so she goes home to work on her biography for an online placement service. In it she makes the following two statements:

Statement 1:	I'm a Level III CFA candidate, and I expect to receive my charter this fall. The CFA program is a grueling, 3-part, graduate-level course, and passage requires an expertise in a variety of financial instruments, as well as knowledge of the forces that drive our economy and financial markets.
Statement 2:	I expect to graduate with my MBA from Braxton College at the end of the fall semester. As both an MBA and a CFA, I'll be in high demand. Hire me now while you still have the chance.

Akshay Nagoree, CFA, is a portfolio manager for several pension funds at Samson. His wife is treasurer and 15% shareholder of Gatedon Electric. The market value of Mrs. Nagoree's Gatedon shares is now $2 million. Samson's research department is recommending the stock to its trust officers and pension fund portfolio managers. Samson has adopted CFA Institute's Research Objectivity Standards.

.....

Did Garvey violate Standard II(A) Material Nonpublic Information when she purchased Vallo and Metrona?

A) Buying Vallo was a violation.

B) Buying Metrona was a violation.

B) Buying Metrona was a violation.

C) Neither purchase was a violation.

Question #4 of 60

Question ID: 609992

Glenda Garvey is interning at Samson Financial in the summer to earn money for her last semester of MBA studies. She took the Level III CFA® exam in June but has not yet received her results. Garvey's work involves preparing research reports on small companies.

Garvey is at lunch with a group of co-workers. She listens to their conversation about various stocks and takes note of a comment from Tony Topel, a veteran analyst. Topel is talking about Vallo Engineering, a small stock he has tried repeatedly to convince the investment director to add to the monitored list. While the investment director does not like Vallo, Topel has faith in the company and has gradually accumulated 5,000 shares for his own account. Another analyst, Mary Kennedy, tells the group about Koral Koatings, a paint and sealant manufacturer. Kennedy has spent most of the last week at the office doing research on Koral. She has concluded that the stock is undervalued and consensus earnings estimates are conservative. However, she has not filed a report for Samson, nor does she intend to. She said she has purchased the stock for herself and advises her colleagues to do the same. After she gets back to the office, Garvey purchases 25 shares of Vallo and 50 shares of Koral for herself.

Samson pays its interns very little, and Garvey works as a waitress at a diner in the financial district to supplement her income. The dinner crowd includes many analysts and brokers who work at nearby businesses. While waiting tables that night, Garvey hears two employees of a major brokerage house discussing Metrona, a nanotechnology company. The restaurant patrons say that the broker's star analyst has issued a report with a buy rating on Metrona that morning. The diners plan to buy the stock the next morning. After Garvey finishes her shift, restaurant manager Mandy Jones, a longtime Samson client, asks to speak with her. Jones commends Garvey for her hard work at the restaurant, praising her punctuality and positive attitude, and offers her two tickets to a Yankees game as a bonus.

The next morning, Garvey buys 40 shares of Metrona for her own account at the market open. Soon afterward, she receives a call from Harold Koons, one of Samson's largest money-management clients. Koons says he got Garvey's name from Bertha Witt, who manages the Koons's account. Koons wanted to reward the analyst who discovered Anvil Hammers, a machine-tool company whose stock soared soon after it was added to his portfolio. Garvey prepared the original report on Anvil Hammers. Koons offers Garvey two free round-trip tickets to the city of her choice. Garvey thanks Koons, then asks her immediate supervisor, Karl May, about the gift from Koons but does not mention the gift from Jones. May approves the Koons' gift.

After talking with May, Garvey starts a research project on Zenith Enterprises, a frozen-juice maker. Garvey's gathers quarterly data on the company's sales and profits over the past two years. Garvey uses a simple linear regression to estimate the relationship between GDP growth and Zenith's sales growth. Next she uses a consensus GDP estimate from a well-known economic data reporting service and her regression model to extrapolate growth rates for the next three years.

Garvey is not working at the diner that night, so she goes home to work on her biography for an online placement service. In it she makes the following two statements:

Statement 1: I'm a Level III CFA candidate, and I expect to receive my charter this fall. The CFA program is a grueling, 3-part, graduate-level course, and passage requires an expertise in a

variety of financial instruments, as well as knowledge of the forces that drive our economy and financial markets.

Statement 2: I expect to graduate with my MBA from Braxton College at the end of the fall semester. As both an MBA and a CFA, I'll be in high demand. Hire me now while you still have the chance.

Akshay Nagoree, CFA, is a portfolio manager for several pension funds at Samson. His wife is treasurer and 15% shareholder of Gatedon Electric. The market value of Mrs. Nagoree's Gatedon shares is now $2 million. Samson's research department is recommending the stock to its trust officers and pension fund portfolio managers. Samson has adopted CFA Institute's Research Objectivity Standards.

.....

In her estimation of Zenith's future growth rate, what standard did Garvey violate?

A) Standard I(C) Misrepresentation regarding plagiarism.

B) Standard V(A) Diligence and Reasonable Basis.

C) Both I(C) and V(A).

Question #5 of 60

Question ID: 609993

Glenda Garvey is interning at Samson Financial in the summer to earn money for her last semester of MBA studies. She took the Level III CFA® exam in June but has not yet received her results. Garvey's work involves preparing research reports on small companies.

Garvey is at lunch with a group of co-workers. She listens to their conversation about various stocks and takes note of a comment from Tony Topel, a veteran analyst. Topel is talking about Vallo Engineering, a small stock he has tried repeatedly to convince the investment director to add to the monitored list. While the investment director does not like Vallo, Topel has faith in the company and has gradually accumulated 5,000 shares for his own account. Another analyst, Mary Kennedy, tells the group about Koral Koatings, a paint and sealant manufacturer. Kennedy has spent most of the last week at the office doing research on Koral. She has concluded that the stock is undervalued and consensus earnings estimates are conservative. However, she has not filed a report for Samson, nor does she intend to. She said she has purchased the stock for herself and advises her colleagues to do the same. After she gets back to the office, Garvey purchases 25 shares of Vallo and 50 shares of Koral for herself.

Samson pays its interns very little, and Garvey works as a waitress at a diner in the financial district to supplement her income. The dinner crowd includes many analysts and brokers who work at nearby businesses. While waiting tables that night, Garvey hears two employees of a major brokerage house discussing Metrona, a nanotechnology company. The restaurant patrons say that the broker's star analyst has issued a report with a buy rating on Metrona that morning. The diners plan to buy the stock the next morning. After Garvey finishes her shift, restaurant manager Mandy Jones, a longtime Samson client, asks to speak with her. Jones commends Garvey for her hard work at the restaurant, praising her punctuality and positive attitude, and offers her two tickets to a Yankees game as a bonus.

The next morning, Garvey buys 40 shares of Metrona for her own account at the market open. Soon afterward, she receives a call from Harold Koons, one of Samson's largest money-management clients. Koons says he got Garvey's name from Bertha

Witt, who manages the Koons's account. Koons wanted to reward the analyst who discovered Anvil Hammers, a machine-tool company whose stock soared soon after it was added to his portfolio. Garvey prepared the original report on Anvil Hammers. Koons offers Garvey two free round-trip tickets to the city of her choice. Garvey thanks Koons, then asks her immediate supervisor, Karl May, about the gift from Koons but does not mention the gift from Jones. May approves the Koons' gift.

After talking with May, Garvey starts a research project on Zenith Enterprises, a frozen-juice maker. Garvey's gathers quarterly data on the company's sales and profits over the past two years. Garvey uses a simple linear regression to estimate the relationship between GDP growth and Zenith's sales growth. Next she uses a consensus GDP estimate from a well-known economic data reporting service and her regression model to extrapolate growth rates for the next three years.

Garvey is not working at the diner that night, so she goes home to work on her biography for an online placement service. In it she makes the following two statements:

Statement 1:	I'm a Level III CFA candidate, and I expect to receive my charter this fall. The CFA program is a grueling, 3-part, graduate-level course, and passage requires an expertise in a variety of financial instruments, as well as knowledge of the forces that drive our economy and financial markets.
Statement 2:	I expect to graduate with my MBA from Braxton College at the end of the fall semester. As both an MBA and a CFA, I'll be in high demand. Hire me now while you still have the chance.

Akshay Nagoree, CFA, is a portfolio manager for several pension funds at Samson. His wife is treasurer and 15% shareholder of Gatedon Electric. The market value of Mrs. Nagoree's Gatedon shares is now $2 million. Samson's research department is recommending the stock to its trust officers and pension fund portfolio managers. Samson has adopted CFA Institute's Research Objectivity Standards.

.....

Did the two statements in Garvey's biography violate Standard VII(B) Reference to CFA Institute, the CFA designation, and the CFA program?

A) Statement 1 is a violation.

B) Statement 2 is a violation.

C) Both statements are violations.

Question #6 of 60

Question ID: 610000

Glenda Garvey is interning at Samson Financial in the summer to earn money for her last semester of MBA studies. She took the Level III CFA® exam in June but has not yet received her results. Garvey's work involves preparing research reports on small companies.

Garvey is at lunch with a group of co-workers. She listens to their conversation about various stocks and takes note of a comment from Tony Topel, a veteran analyst. Topel is talking about Vallo Engineering, a small stock he has tried repeatedly to convince the investment director to add to the monitored list. While the investment director does not like Vallo, Topel has faith in the company and has gradually accumulated 5,000 shares for his own account. Another analyst, Mary Kennedy, tells the

group about Koral Koatings, a paint and sealant manufacturer. Kennedy has spent most of the last week at the office doing research on Koral. She has concluded that the stock is undervalued and consensus earnings estimates are conservative. However, she has not filed a report for Samson, nor does she intend to. She said she has purchased the stock for herself and advises her colleagues to do the same. After she gets back to the office, Garvey purchases 25 shares of Vallo and 50 shares of Koral for herself.

Samson pays its interns very little, and Garvey works as a waitress at a diner in the financial district to supplement her income. The dinner crowd includes many analysts and brokers who work at nearby businesses. While waiting tables that night, Garvey hears two employees of a major brokerage house discussing Metrona, a nanotechnology company. The restaurant patrons say that the broker's star analyst has issued a report with a buy rating on Metrona that morning. The diners plan to buy the stock the next morning. After Garvey finishes her shift, restaurant manager Mandy Jones, a longtime Samson client, asks to speak with her. Jones commends Garvey for her hard work at the restaurant, praising her punctuality and positive attitude, and offers her two tickets to a Yankees game as a bonus.

The next morning, Garvey buys 40 shares of Metrona for her own account at the market open. Soon afterward, she receives a call from Harold Koons, one of Samson's largest money-management clients. Koons says he got Garvey's name from Bertha Witt, who manages the Koons's account. Koons wanted to reward the analyst who discovered Anvil Hammers, a machine-tool company whose stock soared soon after it was added to his portfolio. Garvey prepared the original report on Anvil Hammers. Koons offers Garvey two free round-trip tickets to the city of her choice. Garvey thanks Koons, then asks her immediate supervisor, Karl May, about the gift from Koons but does not mention the gift from Jones. May approves the Koons' gift.

After talking with May, Garvey starts a research project on Zenith Enterprises, a frozen-juice maker. Garvey's gathers quarterly data on the company's sales and profits over the past two years. Garvey uses a simple linear regression to estimate the relationship between GDP growth and Zenith's sales growth. Next she uses a consensus GDP estimate from a well-known economic data reporting service and her regression model to extrapolate growth rates for the next three years.

Garvey is not working at the diner that night, so she goes home to work on her biography for an online placement service. In it she makes the following two statements:

Statement 1:	I'm a Level III CFA candidate, and I expect to receive my charter this fall. The CFA program is a grueling, 3-part, graduate-level course, and passage requires an expertise in a variety of financial instruments, as well as knowledge of the forces that drive our economy and financial markets.
Statement 2:	I expect to graduate with my MBA from Braxton College at the end of the fall semester. As both an MBA and a CFA, I'll be in high demand. Hire me now while you still have the chance.

Akshay Nagoree, CFA, is a portfolio manager for several pension funds at Samson. His wife is treasurer and 15% shareholder of Gatedon Electric. The market value of Mrs. Nagoree's Gatedon shares is now $2 million. Samson's research department is recommending the stock to its trust officers and pension fund portfolio managers. Samson has adopted CFA Institute's Research Objectivity Standards.

.....

Based on the Research Objectivity Standards, which of the following is Nagoree's *most appropriate* course of action for the accounts under his management?

A) Nagoree is permitted to buy Gatedon stock without stipulation because it is his wife

A) Nagoree is permitted to buy Gatedon stock without stipulation because it is his wife, not he, who is a shareholder in Gatedon.

B) Nagoree is permitted to buy the stock after disclosing his wife's ownership to his supervisor and to the trustees of all the pension funds he manages.

C) Nagoree is prohibited from buying the stock because of his inability to render an unbiased and objective investment opinion given his wife's affiliation with the company.

Question #7 of 60

Question ID: 609994

Questions 7-12 relate to Maria Harris.

Maria Harris is a CFA® Level III candidate and portfolio manager for Islandwide Hedge Fund. Harris is commonly involved in complex trading strategies on behalf of Islandwide and maintains a significant relationship with Quadrangle Brokers, which provides portfolio analysis tools to Harris. Recent market volatility has led Islandwide to incur record-high trading volume and commissions with Quadrangle for the quarter. In appreciation of Islandwide's business, Quadrangle offers Harris an all-expenses-paid week of golf at Pebble Beach for her and her husband. Harris discloses the offer to her supervisor and compliance officer and, based on their approval, accepts the trip.

Harris has lunch that day with C. K. Swamy, CFA, her old college roommate and future sister-in-law. While Harris is sitting in the restaurant waiting for Swamy to arrive, Harris overhears a conversation between the president and chief financial officer (CFO) of Progressive Industries. The president informs the CFO that Progressive's board of directors has just approved dropping the company's cash dividend, despite its record of paying dividends for the past 46 quarters. The company plans to announce this information in about a week. Harris owns Progressive's common stock and immediately calls her broker to sell her shares in anticipation of a price decline.

Swamy recently joined Dillon Associates, an investment advisory firm as an equity analyst. Swamy plans to continue serving on the board of directors of Landmark Enterprises, a private company specializing in online gaming owned by her brother-in-law, for which she receives $2,000 annually. Swamy also serves as an unpaid advisor to the local symphony on investing their large endowment and receives four season tickets to the symphony performances.

After lunch, Alice Adams, a client, offers Harris a 1-week cruise as a reward for the great performance of her account over the previous quarter. Bert Baker, also a client, has offered Harris two airplane tickets to Hawaii if his account beats its benchmark by more than 2% over the following year.

Juliann Clark, a CFA candidate, is an analyst at Dillon Associates and a colleague of Swamy's. Clark participates in a conference call for several analysts in which the chief executive officer at Dex says his company's board of directors has just accepted a tender offer from Monolith Chemicals to buy Dex at a 40% premium over the market price. Clark contacts a friend and relates the information about Dex and Monolith. The friend promptly contacts her broker and buys 2,000 shares of Dex's stock.

Ed Michaels, CFA, is director of trading at Quadrangle Brokers. Michaels has recently implemented a buy program for a client. This buy program has driven up the price of a small-cap stock, in which Islandwide owns shares, by approximately 5% because the orders were large in relation to the average daily trading volume of the stock. Michaels's firm is about to bring shares of an OTC firm to market in an IPO. Michaels has publicly announced that, as a market maker in the shares, his trading desk will create additional liquidity in the stock over its first 90 days of trading by committing to minimum bids and offers of

5,000 shares and to a maximum spread of one-eighth.

Carl Park, CFA, is a retail broker with Quadrangle and has been allocated 5,000 shares of an oversubscribed IPO. One of his clients has been complaining about the execution price of a trade Park made for her last month, but Park knows from researching it that the trade received the best possible execution. In order to calm the client down, Park increases her allocation of shares in the IPO above what it would be if he allocated them to all suitable client accounts based on account size. He allocates a pro-rata portion of the remaining shares to a trust account held at his firm for which his brother-in-law is the primary beneficiary.

.....

By accepting the trip from Quadrangle, has Harris complied with the CFA Institute Code and Standards?

A) Harris may accept the trip because she maintains a significant relationship with Quadrangle that contributes to the performance of client accounts.

B) Harris may accept the trip because she disclosed the trip to her supervisor and compliance officer and accepted based on their approval.

C) Harris may not accept the trip because the offer from Quadrangle could impede her ability to make objective investment decisions on behalf of the client.

Question #8 of 60

Question ID: 609995

Maria Harris is a CFA® Level III candidate and portfolio manager for Islandwide Hedge Fund. Harris is commonly involved in complex trading strategies on behalf of Islandwide and maintains a significant relationship with Quadrangle Brokers, which provides portfolio analysis tools to Harris. Recent market volatility has led Islandwide to incur record-high trading volume and commissions with Quadrangle for the quarter. In appreciation of Islandwide's business, Quadrangle offers Harris an all-expenses-paid week of golf at Pebble Beach for her and her husband. Harris discloses the offer to her supervisor and compliance officer and, based on their approval, accepts the trip.

Harris has lunch that day with C. K. Swamy, CFA, her old college roommate and future sister-in-law. While Harris is sitting in the restaurant waiting for Swamy to arrive, Harris overhears a conversation between the president and chief financial officer (CFO) of Progressive Industries. The president informs the CFO that Progressive's board of directors has just approved dropping the company's cash dividend, despite its record of paying dividends for the past 46 quarters. The company plans to announce this information in about a week. Harris owns Progressive's common stock and immediately calls her broker to sell her shares in anticipation of a price decline.

Swamy recently joined Dillon Associates, an investment advisory firm as an equity analyst. Swamy plans to continue serving on the board of directors of Landmark Enterprises, a private company specializing in online gaming owned by her brother-in-law, for which she receives $2,000 annually. Swamy also serves as an unpaid advisor to the local symphony on investing their large endowment and receives four season tickets to the symphony performances.

After lunch, Alice Adams, a client, offers Harris a 1-week cruise as a reward for the great performance of her account over the previous quarter. Bert Baker, also a client, has offered Harris two airplane tickets to Hawaii if his account beats its benchmark by more than 2% over the following year.

Julianne Clark, a CFA candidate, is an analyst at Dillon Associates and a colleague of Swamy's. Clark participates in a conference call for several analysts in which the chief executive officer at Dex says his company's board of directors has just accepted a tender offer from Monolith Chemicals to buy Dex at a 40% premium over the market price. Clark contacts a friend and relates the information about Dex and Monolith. The friend promptly contacts her broker and buys 2,000 shares of Dex's stock.

Ed Michaels, CFA, is director of trading at Quadrangle Brokers. Michaels has recently implemented a buy program for a client. This buy program has driven up the price of a small-cap stock, in which Islandwide owns shares, by approximately 5% because the orders were large in relation to the average daily trading volume of the stock. Michaels's firm is about to bring shares of an OTC firm to market in an IPO. Michaels has publicly announced that, as a market maker in the shares, his trading desk will create additional liquidity in the stock over its first 90 days of trading by committing to minimum bids and offers of 5,000 shares and to a maximum spread of one-eighth.

Carl Park, CFA, is a retail broker with Quadrangle and has been allocated 5,000 shares of an oversubscribed IPO. One of his clients has been complaining about the execution price of a trade Park made for her last month, but Park knows from researching it that the trade received the best possible execution. In order to calm the client down, Park increases her allocation of shares in the IPO above what it would be if he allocated them to all suitable client accounts based on account size. He allocates a pro-rata portion of the remaining shares to a trust account held at his firm for which his brother-in-law is the primary beneficiary.

.....

Has either Harris or Clark violated Standard II(A) Integrity of Capital Markets: Material Nonpublic Information?

A) Harris is in violation.

B) Clark is in violation.

C) Both are in violation.

Question #9 of 60

Question ID: 609996

Maria Harris is a CFA® Level III candidate and portfolio manager for Islandwide Hedge Fund. Harris is commonly involved in complex trading strategies on behalf of Islandwide and maintains a significant relationship with Quadrangle Brokers, which provides portfolio analysis tools to Harris. Recent market volatility has led Islandwide to incur record-high trading volume and commissions with Quadrangle for the quarter. In appreciation of Islandwide's business, Quadrangle offers Harris an all-expenses-paid week of golf at Pebble Beach for her and her husband. Harris discloses the offer to her supervisor and compliance officer and, based on their approval, accepts the trip.

Harris has lunch that day with C. K. Swamy, CFA, her old college roommate and future sister-in-law. While Harris is sitting in the restaurant waiting for Swamy to arrive, Harris overhears a conversation between the president and chief financial officer (CFO) of Progressive Industries. The president informs the CFO that Progressive's board of directors has just approved dropping the company's cash dividend, despite its record of paying dividends for the past 46 quarters. The company plans to announce this information in about a week. Harris owns Progressive's common stock and immediately calls her broker to sell her shares in anticipation of a price decline.

Swamy recently joined Dillon Associates, an investment advisory firm as an equity analyst. Swamy plans to continue serving

on the board of directors of Landmark Enterprises, a private company specializing in online gaming owned by her brother-in-law, for which she receives $2,000 annually. Swamy also serves as an unpaid advisor to the local symphony on investing their large endowment and receives four season tickets to the symphony performances.

After lunch, Alice Adams, a client, offers Harris a 1-week cruise as a reward for the great performance of her account over the previous quarter. Bert Baker, also a client, has offered Harris two airplane tickets to Hawaii if his account beats its benchmark by more than 2% over the following year.

Juliann Clark, a CFA candidate, is an analyst at Dillon Associates and a colleague of Swamy's. Clark participates in a conference call for several analysts in which the chief executive officer at Dex says his company's board of directors has just accepted a tender offer from Monolith Chemicals to buy Dex at a 40% premium over the market price. Clark contacts a friend and relates the information about Dex and Monolith. The friend promptly contacts her broker and buys 2,000 shares of Dex's stock.

Ed Michaels, CFA, is director of trading at Quadrangle Brokers. Michaels has recently implemented a buy program for a client. This buy program has driven up the price of a small-cap stock, in which Islandwide owns shares, by approximately 5% because the orders were large in relation to the average daily trading volume of the stock. Michaels's firm is about to bring shares of an OTC firm to market in an IPO. Michaels has publicly announced that, as a market maker in the shares, his trading desk will create additional liquidity in the stock over its first 90 days of trading by committing to minimum bids and offers of 5,000 shares and to a maximum spread of one-eighth.

Carl Park, CFA, is a retail broker with Quadrangle and has been allocated 5,000 shares of an oversubscribed IPO. One of his clients has been complaining about the execution price of a trade Park made for her last month, but Park knows from researching it that the trade received the best possible execution. In order to calm the client down, Park increases her allocation of shares in the IPO above what it would be if he allocated them to all suitable client accounts based on account size. He allocates a pro-rata portion of the remaining shares to a trust account held at his firm for which his brother-in-law is the primary beneficiary.

.....

According to the Standards of Practice, with respect to the two offers from Adams and Baker, Harris:

A) may accept both offers if she discloses them to her employer.

B) may accept both gifts only if she discloses them to her employer and receives permission.

C) must disclose the offer from Adams to her employer if she accepts it but must receive her employer's permission to accept the offer from Baker.

Question #10 of 60

Question ID: 609997

Maria Harris is a CFA® Level III candidate and portfolio manager for Islandwide Hedge Fund. Harris is commonly involved in complex trading strategies on behalf of Islandwide and maintains a significant relationship with Quadrangle Brokers, which provides portfolio analysis tools to Harris. Recent market volatility has led Islandwide to incur record-high trading volume and commissions with Quadrangle for the quarter. In appreciation of Islandwide's business, Quadrangle offers Harris an all-expenses-paid week of golf at Pebble Beach for her and her husband. Harris discloses the offer to her supervisor and

compliance officer and, based on their approval, accepts the trip.

Harris has lunch that day with C. K. Swamy, CFA, her old college roommate and future sister-in-law. While Harris is sitting in the restaurant waiting for Swamy to arrive, Harris overhears a conversation between the president and chief financial officer (CFO) of Progressive Industries. The president informs the CFO that Progressive's board of directors has just approved dropping the company's cash dividend, despite its record of paying dividends for the past 46 quarters. The company plans to announce this information in about a week. Harris owns Progressive's common stock and immediately calls her broker to sell her shares in anticipation of a price decline.

Swamy recently joined Dillon Associates, an investment advisory firm as an equity analyst. Swamy plans to continue serving on the board of directors of Landmark Enterprises, a private company specializing in online gaming owned by her brother-in-law, for which she receives $2,000 annually. Swamy also serves as an unpaid advisor to the local symphony on investing their large endowment and receives four season tickets to the symphony performances.

After lunch, Alice Adams, a client, offers Harris a 1-week cruise as a reward for the great performance of her account over the previous quarter. Bert Baker, also a client, has offered Harris two airplane tickets to Hawaii if his account beats its benchmark by more than 2% over the following year.

Juliann Clark, a CFA candidate, is an analyst at Dillon Associates and a colleague of Swamy's. Clark participates in a conference call for several analysts in which the chief executive officer at Dex says his company's board of directors has just accepted a tender offer from Monolith Chemicals to buy Dex at a 40% premium over the market price. Clark contacts a friend and relates the information about Dex and Monolith. The friend promptly contacts her broker and buys 2,000 shares of Dex's stock.

Ed Michaels, CFA, is director of trading at Quadrangle Brokers. Michaels has recently implemented a buy program for a client. This buy program has driven up the price of a small-cap stock, in which Islandwide owns shares, by approximately 5% because the orders were large in relation to the average daily trading volume of the stock. Michaels's firm is about to bring shares of an OTC firm to market in an IPO. Michaels has publicly announced that, as a market maker in the shares, his trading desk will create additional liquidity in the stock over its first 90 days of trading by committing to minimum bids and offers of 5,000 shares and to a maximum spread of one-eighth.

Carl Park, CFA, is a retail broker with Quadrangle and has been allocated 5,000 shares of an oversubscribed IPO. One of his clients has been complaining about the execution price of a trade Park made for her last month, but Park knows from researching it that the trade received the best possible execution. In order to calm the client down, Park increases her allocation of shares in the IPO above what it would be if he allocated them to all suitable client accounts based on account size. He allocates a pro-rata portion of the remaining shares to a trust account held at his firm for which his brother-in-law is the primary beneficiary.

.....

Has Michaels violated Standard II(B) Integrity of Capital Markets: Market Manipulation with respect to any of the following?

A) The buy program is a violation.

B) The liquidity activity is a violation.

C) There is no violation.

Question #11 of 60

Question ID: 609998

Maria Harris is a CFA® Level III candidate and portfolio manager for Islandwide Hedge Fund. Harris is commonly involved in complex trading strategies on behalf of Islandwide and maintains a significant relationship with Quadrangle Brokers, which provides portfolio analysis tools to Harris. Recent market volatility has led Islandwide to incur record-high trading volume and commissions with Quadrangle for the quarter. In appreciation of Islandwide's business, Quadrangle offers Harris an all-expenses-paid week of golf at Pebble Beach for her and her husband. Harris discloses the offer to her supervisor and compliance officer and, based on their approval, accepts the trip.

Harris has lunch that day with C. K. Swamy, CFA, her old college roommate and future sister-in-law. While Harris is sitting in the restaurant waiting for Swamy to arrive, Harris overhears a conversation between the president and chief financial officer (CFO) of Progressive Industries. The president informs the CFO that Progressive's board of directors has just approved dropping the company's cash dividend, despite its record of paying dividends for the past 46 quarters. The company plans to announce this information in about a week. Harris owns Progressive's common stock and immediately calls her broker to sell her shares in anticipation of a price decline.

Swamy recently joined Dillon Associates, an investment advisory firm as an equity analyst. Swamy plans to continue serving on the board of directors of Landmark Enterprises, a private company specializing in online gaming owned by her brother-in-law, for which she receives $2,000 annually. Swamy also serves as an unpaid advisor to the local symphony on investing their large endowment and receives four season tickets to the symphony performances.

After lunch, Alice Adams, a client, offers Harris a 1-week cruise as a reward for the great performance of her account over the previous quarter. Bert Baker, also a client, has offered Harris two airplane tickets to Hawaii if his account beats its benchmark by more than 2% over the following year.

Juliann Clark, a CFA candidate, is an analyst at Dillon Associates and a colleague of Swamy's. Clark participates in a conference call for several analysts in which the chief executive officer at Dex says his company's board of directors has just accepted a tender offer from Monolith Chemicals to buy Dex at a 40% premium over the market price. Clark contacts a friend and relates the information about Dex and Monolith. The friend promptly contacts her broker and buys 2,000 shares of Dex's stock.

Ed Michaels, CFA, is director of trading at Quadrangle Brokers. Michaels has recently implemented a buy program for a client. This buy program has driven up the price of a small-cap stock, in which Islandwide owns shares, by approximately 5% because the orders were large in relation to the average daily trading volume of the stock. Michaels's firm is about to bring shares of an OTC firm to market in an IPO. Michaels has publicly announced that, as a market maker in the shares, his trading desk will create additional liquidity in the stock over its first 90 days of trading by committing to minimum bids and offers of 5,000 shares and to a maximum spread of one-eighth.

Carl Park, CFA, is a retail broker with Quadrangle and has been allocated 5,000 shares of an oversubscribed IPO. One of his clients has been complaining about the execution price of a trade Park made for her last month, but Park knows from researching it that the trade received the best possible execution. In order to calm the client down, Park increases her allocation of shares in the IPO above what it would be if he allocated them to all suitable client accounts based on account size. He allocates a pro-rata portion of the remaining shares to a trust account held at his firm for which his brother-in-law is the primary beneficiary.

.....

According to Standard IV Duties to Employers, which of the following is *most likely* required of Swamy? Swamy must:

A) secure written permission from her employer before performing services for the symphony.

B) inform her immediate supervisor at Dillon in writing that she (Swamy) must comply with the Code and Standards.

C) disclose to her employer any additional compensation she receives from Landmark Enterprises and secure written permission to serve on the board.

Question #12 of 60

Question ID: 609999

Maria Harris is a CFA® Level III candidate and portfolio manager for Islandwide Hedge Fund. Harris is commonly involved in complex trading strategies on behalf of Islandwide and maintains a significant relationship with Quadrangle Brokers, which provides portfolio analysis tools to Harris. Recent market volatility has led Islandwide to incur record-high trading volume and commissions with Quadrangle for the quarter. In appreciation of Islandwide's business, Quadrangle offers Harris an all-expenses-paid week of golf at Pebble Beach for her and her husband. Harris discloses the offer to her supervisor and compliance officer and, based on their approval, accepts the trip.

Harris has lunch that day with C. K. Swamy, CFA, her old college roommate and future sister-in-law. While Harris is sitting in the restaurant waiting for Swamy to arrive, Harris overhears a conversation between the president and chief financial officer (CFO) of Progressive Industries. The president informs the CFO that Progressive's board of directors has just approved dropping the company's cash dividend, despite its record of paying dividends for the past 46 quarters. The company plans to announce this information in about a week. Harris owns Progressive's common stock and immediately calls her broker to sell her shares in anticipation of a price decline.

Swamy recently joined Dillon Associates, an investment advisory firm as an equity analyst. Swamy plans to continue serving on the board of directors of Landmark Enterprises, a private company specializing in online gaming owned by her brother-in-law, for which she receives $2,000 annually. Swamy also serves as an unpaid advisor to the local symphony on investing their large endowment and receives four season tickets to the symphony performances.

After lunch, Alice Adams, a client, offers Harris a 1-week cruise as a reward for the great performance of her account over the previous quarter. Bert Baker, also a client, has offered Harris two airplane tickets to Hawaii if his account beats its benchmark by more than 2% over the following year.

Juliann Clark, a CFA candidate, is an analyst at Dillon Associates and a colleague of Swamy's. Clark participates in a conference call for several analysts in which the chief executive officer at Dex says his company's board of directors has just accepted a tender offer from Monolith Chemicals to buy Dex at a 40% premium over the market price. Clark contacts a friend and relates the information about Dex and Monolith. The friend promptly contacts her broker and buys 2,000 shares of Dex's stock.

Ed Michaels, CFA, is director of trading at Quadrangle Brokers. Michaels has recently implemented a buy program for a client. This buy program has driven up the price of a small-cap stock, in which Islandwide owns shares, by approximately 5% because the orders were large in relation to the average daily trading volume of the stock. Michaels's firm is about to bring shares of an OTC firm to market in an IPO. Michaels has publicly announced that, as a market maker in the shares, his trading desk will create additional liquidity in the stock over its first 90 days of trading by committing to minimum bids and offers of 5,000 shares and to a maximum spread of one-eighth.

5,000 shares and to a maximum spread of one-eighth.

Carl Park, CFA, is a retail broker with Quadrangle and has been allocated 5,000 shares of an oversubscribed IPO. One of his clients has been complaining about the execution price of a trade Park made for her last month, but Park knows from researching it that the trade received the best possible execution. In order to calm the client down, Park increases her allocation of shares in the IPO above what it would be if he allocated them to all suitable client accounts based on account size. He allocates a pro-rata portion of the remaining shares to a trust account held at his firm for which his brother-in-law is the primary beneficiary.

.....

Which action by Park violated Standard III(B) Duties to Clients: Fair Dealing?

A) Increasing allocation to the problem client.

B) Decreased allocation to the brother-in-law and other firm clients.

C) Both actions are violations.

Question #13 of 60

Question ID: 691216

Questions 13-18 relate to Barton Wilson.

Barton Wilson, a junior analyst, is a new hire at a money center bank. He has been assigned to help Juanita Chevas, CFA, in the currency trading department. Together, Wilson and Chevas are working on the development of new trading software designed to detect profitable opportunities in the foreign exchange market. Obviously, they are interested in risk-free arbitrage opportunities. However, they have also been instructed to investigate the possibility of longer-term currency exposures that are not necessarily risk-free. To test the logic of their new software, Wilson gathers the following market data:

- Spot JPY/USD exchange rate = 120.
- Spot EUR/USD exchange rate = 0.7224.
- U.S. risk-free interest rate = 7%.
- Eurozone risk-free rate = 9.08%.
- Japanese risk-free rate = 3.88%.
- Yield curves in all three currencies are flat.

In addition to in-house currency transactions, the new software program is also intended to provide insight into currency exposure and hedging needs for the bank's major customers. These customers typically include large multinational firms. Essentially, the bank wants to provide consulting services to its clients concerning which currency exposures offer the most lucrative opportunities. In this process, the bank will rely on deviations from international parity conditions as an indicator of long-term currency movements. Several bank customers have engaged in a carry trade with Bundovian Bunco (BU) as the investment currency and the USD as the funding currency. The bank will provide risk management advice to customers as it pertains to their FX carry trades.

Wilson obtains the following data from the econometrics department:

- JPY/USD spot rate one year ago = 116.
- EUR/USD spot rate one year ago = 0.7200.
- Anticipated and historical U.S. annual inflation = 3%

- Anticipated and historical U.S. annual inflation = 3%.
- Anticipated and historical Japanese annual inflation = 0%.
- Anticipated and historical Eurozone annual inflation = 5%.

One of the bank's major customers has significant business interests in Japan and in the Eurozone and has long exposure to both currencies. The customer has traditionally hedged all currency risk. However, the customer's new risk manager has decided to leave some currency exposure unhedged in an attempt to profit from long-term currency exposure.

.....

According to relative purchasing power parity, the expected JPY/EUR spot rate two years from now is closest to:

A) 150.67.

B) 158.29.

C) 166.74.

Question #14 of 60

Question ID: 691215

Barton Wilson, a junior analyst, is a new hire at a money center bank. He has been assigned to help Juanita Chevas, CFA, in the currency trading department. Together, Wilson and Chevas are working on the development of new trading software designed to detect profitable opportunities in the foreign exchange market. Obviously, they are interested in risk-free arbitrage opportunities. However, they have also been instructed to investigate the possibility of longer-term currency exposures that are not necessarily risk-free. To test the logic of their new software, Wilson gathers the following market data:

- Spot JPY/USD exchange rate = 120.
- Spot EUR/USD exchange rate = 0.7224.
- U.S. risk-free interest rate = 7%.
- Eurozone risk-free rate = 9.08%.
- Japanese risk-free rate = 3.88%.
- Yield curves in all three currencies are flat.

In addition to in-house currency transactions, the new software program is also intended to provide insight into currency exposure and hedging needs for the bank's major customers. These customers typically include large multinational firms. Essentially, the bank wants to provide consulting services to its clients concerning which currency exposures offer the most lucrative opportunities. In this process, the bank will rely on deviations from international parity conditions as an indicator of long-term currency movements. Several bank customers have engaged in a carry trade with Bundovian Bunco (BU) as the investment currency and the USD as the funding currency. The bank will provide risk management advice to customers as it pertains to their FX carry trades.

Wilson obtains the following data from the econometrics department:

- JPY/USD spot rate one year ago = 116.
- EUR/USD spot rate one year ago = 0.7200.
- Anticipated and historical U.S. annual inflation = 3%.
- Anticipated and historical Japanese annual inflation = 0%.
- Anticipated and historical Eurozone annual inflation = 5%.

- Anticipated and historical Eurozone annual inflation = 5%.

One of the bank's major customers has significant business interests in Japan and in the Eurozone and has long exposure to both currencies. The customer has traditionally hedged all currency risk. However, the customer's new risk manager has decided to leave some currency exposure unhedged in an attempt to profit from long-term currency exposure.

.....

Are the Japanese and Eurozone inflation forecasts provided by the econometrics department consistent with the inflation rates implied by the international Fisher relation, given a U.S. inflation rate of 3%?

A) Both forecasts are consistent.

B) Neither forecast is consistent.

C) One forecast is consistent and the other is not.

Question #15 of 60

Question ID: 691217

Barton Wilson, a junior analyst, is a new hire at a money center bank. He has been assigned to help Juanita Chevas, CFA, in the currency trading department. Together, Wilson and Chevas are working on the development of new trading software designed to detect profitable opportunities in the foreign exchange market. Obviously, they are interested in risk-free arbitrage opportunities. However, they have also been instructed to investigate the possibility of longer-term currency exposures that are not necessarily risk-free. To test the logic of their new software, Wilson gathers the following market data:

- Spot JPY/USD exchange rate = 120.
- Spot EUR/USD exchange rate = 0.7224.
- U.S. risk-free interest rate = 7%.
- Eurozone risk-free rate = 9.08%.
- Japanese risk-free rate = 3.88%.
- Yield curves in all three currencies are flat.

In addition to in-house currency transactions, the new software program is also intended to provide insight into currency exposure and hedging needs for the bank's major customers. These customers typically include large multinational firms. Essentially, the bank wants to provide consulting services to its clients concerning which currency exposures offer the most lucrative opportunities. In this process, the bank will rely on deviations from international parity conditions as an indicator of long-term currency movements. Several bank customers have engaged in a carry trade with Bundovian Bunco (BU) as the investment currency and the USD as the funding currency. The bank will provide risk management advice to customers as it pertains to their FX carry trades.

Wilson obtains the following data from the econometrics department:

- JPY/USD spot rate one year ago = 116.
- EUR/USD spot rate one year ago = 0.7200.
- Anticipated and historical U.S. annual inflation = 3%.
- Anticipated and historical Japanese annual inflation = 0%.
- Anticipated and historical Eurozone annual inflation = 5%.

One of the bank's major customers has significant business interests in Japan and in the Eurozone and has long exposure to both currencies. The customer has traditionally hedged all currency risk. However, the customer's new risk manager has decided to leave some currency exposure unhedged in an attempt to profit from long-term currency exposure.

.....

According to the uncovered interest rate parity, in 12 months, the JPY/USD exchange rate would *most likely* be:

A) 116.50.

B) 123.74.

C) 117.96.

Question #16 of 60

Question ID: 691220

Barton Wilson, a junior analyst, is a new hire at a money center bank. He has been assigned to help Juanita Chevas, CFA, in the currency trading department. Together, Wilson and Chevas are working on the development of new trading software designed to detect profitable opportunities in the foreign exchange market. Obviously, they are interested in risk-free arbitrage opportunities. However, they have also been instructed to investigate the possibility of longer-term currency exposures that are not necessarily risk-free. To test the logic of their new software, Wilson gathers the following market data:

- Spot JPY/USD exchange rate = 120.
- Spot EUR/USD exchange rate = 0.7224.
- U.S. risk-free interest rate = 7%.
- Eurozone risk-free rate = 9.08%.
- Japanese risk-free rate = 3.88%.
- Yield curves in all three currencies are flat.

In addition to in-house currency transactions, the new software program is also intended to provide insight into currency exposure and hedging needs for the bank's major customers. These customers typically include large multinational firms. Essentially, the bank wants to provide consulting services to its clients concerning which currency exposures offer the most lucrative opportunities. In this process, the bank will rely on deviations from international parity conditions as an indicator of long-term currency movements. Several bank customers have engaged in a carry trade with Bundovian Bunco (BU) as the investment currency and the USD as the funding currency. The bank will provide risk management advice to customers as it pertains to their FX carry trades.

Wilson obtains the following data from the econometrics department:

- JPY/USD spot rate one year ago = 116.
- EUR/USD spot rate one year ago = 0.7200.
- Anticipated and historical U.S. annual inflation = 3%.
- Anticipated and historical Japanese annual inflation = 0%.
- Anticipated and historical Eurozone annual inflation = 5%.

One of the bank's major customers has significant business interests in Japan and in the Eurozone and has long exposure to both currencies. The customer has traditionally hedged all currency risk. However, the customer's new risk manager has

decided to leave some currency exposure unhedged in an attempt to profit from long-term currency exposure.

.....

For this question only, suppose that the Japanese government wants to fix the JPY/USD exchange rate at 100. Under the Mundell-Fleming model, the Japanese government's ability to follow an expansionary monetary policy would be limited by:

A) its fiscal policy.

B) the price sensitivity of its exports to the United States.

C) its USD reserves.

Question #17 of 60

Question ID: 691218

Barton Wilson, a junior analyst, is a new hire at a money center bank. He has been assigned to help Juanita Chevas, CFA, in the currency trading department. Together, Wilson and Chevas are working on the development of new trading software designed to detect profitable opportunities in the foreign exchange market. Obviously, they are interested in risk-free arbitrage opportunities. However, they have also been instructed to investigate the possibility of longer-term currency exposures that are not necessarily risk-free. To test the logic of their new software, Wilson gathers the following market data:

- Spot JPY/USD exchange rate = 120.
- Spot EUR/USD exchange rate = 0.7224.
- U.S. risk-free interest rate = 7%.
- Eurozone risk-free rate = 9.08%.
- Japanese risk-free rate = 3.88%.
- Yield curves in all three currencies are flat.

In addition to in-house currency transactions, the new software program is also intended to provide insight into currency exposure and hedging needs for the bank's major customers. These customers typically include large multinational firms. Essentially, the bank wants to provide consulting services to its clients concerning which currency exposures offer the most lucrative opportunities. In this process, the bank will rely on deviations from international parity conditions as an indicator of long-term currency movements. Several bank customers have engaged in a carry trade with Bundovian Bunco (BU) as the investment currency and the USD as the funding currency. The bank will provide risk management advice to customers as it pertains to their FX carry trades.

Wilson obtains the following data from the econometrics department:

- JPY/USD spot rate one year ago = 116.
- EUR/USD spot rate one year ago = 0.7200.
- Anticipated and historical U.S. annual inflation = 3%.
- Anticipated and historical Japanese annual inflation = 0%.
- Anticipated and historical Eurozone annual inflation = 5%.

One of the bank's major customers has significant business interests in Japan and in the Eurozone and has long exposure to both currencies. The customer has traditionally hedged all currency risk. However, the customer's new risk manager has decided to leave some currency exposure unhedged in an attempt to profit from long-term currency exposure.

Based on the assumption that international parity conditions will hold in the long run, should the JPY and Euro currency exposures of the bank's major customer be left unhedged?

A) Both currencies should be left unhedged.

B) Neither currency should be left unhedged.

C) One currency should be left unhedged and the other should not.

Question #18 of 60

Question ID: 691219

Barton Wilson, a junior analyst, is a new hire at a money center bank. He has been assigned to help Juanita Chevas, CFA, in the currency trading department. Together, Wilson and Chevas are working on the development of new trading software designed to detect profitable opportunities in the foreign exchange market. Obviously, they are interested in risk-free arbitrage opportunities. However, they have also been instructed to investigate the possibility of longer-term currency exposures that are not necessarily risk-free. To test the logic of their new software, Wilson gathers the following market data:

- Spot JPY/USD exchange rate = 120.
- Spot EUR/USD exchange rate = 0.7224.
- U.S. risk-free interest rate = 7%.
- Eurozone risk-free rate = 9.08%.
- Japanese risk-free rate = 3.88%.
- Yield curves in all three currencies are flat.

In addition to in-house currency transactions, the new software program is also intended to provide insight into currency exposure and hedging needs for the bank's major customers. These customers typically include large multinational firms. Essentially, the bank wants to provide consulting services to its clients concerning which currency exposures offer the most lucrative opportunities. In this process, the bank will rely on deviations from international parity conditions as an indicator of long-term currency movements. Several bank customers have engaged in a carry trade with Bundovian Bunco (BU) as the investment currency and the USD as the funding currency. The bank will provide risk management advice to customers as it pertains to their FX carry trades.

Wilson obtains the following data from the econometrics department:

- JPY/USD spot rate one year ago = 116.
- EUR/USD spot rate one year ago = 0.7200.
- Anticipated and historical U.S. annual inflation = 3%.
- Anticipated and historical Japanese annual inflation = 0%.
- Anticipated and historical Eurozone annual inflation = 5%.

One of the bank's major customers has significant business interests in Japan and in the Eurozone and has long exposure to both currencies. The customer has traditionally hedged all currency risk. However, the customer's new risk manager has decided to leave some currency exposure unhedged in an attempt to profit from long-term currency exposure.

The *least appropriate* time for advising that the bank's clients close out their carry trade is when:

A) USD prices of options on BU are high.

B) BU prices of options on Bundovian equities are high.

C) the USD is trading above value implied by trends following trading rules.

Question #19 of 60

Question ID: 691227

Questions 19-24 relate to Snowboards and Skateboards, Inc.

Ota L'Abbe, a supervisor at an investment research firm, has asked one of the junior analysts, Andreas Hally, to draft a research report dealing with various accounting issues.

Excerpts from the request are as follows:

- "There's an exciting company that we're starting to follow these days. It's called Snowboards and Skateboards, Inc. They are a multinational company with operations and a head office based in the resort town of Whistler in western Canada. However, they also have a significant subsidiary located in the United States."
- "Look at the subsidiary and deal with some foreign currency issues, including the specific differences between the temporal and current rate methods of translation, as well as the effect on financial ratios."
- "The attached file contains the September 30, 2008, financial statements of the U.S. subsidiary. Translate the financial statements into Canadian dollars in a manner consistent with U.S. GAAP."

The following are statements from the research report subsequently written by Hally:

Statement 1:	Subsidiaries whose operations are well-integrated with the parent will use the current rate method of translation.
Statement 2:	Self-contained, independent subsidiaries whose operating, investing, and financing activities are primarily located in the local market will use the temporal method of translation.

Snowboards and Skateboards, Inc. (U.S.)	(U.S. dollars)
Balance Sheet as of 9/30/2008	
Cash and accounts receivable	775,000
Inventory	600,000
Property, plant, and equipment (PP&E) - net	730,000
Total assets	2,105,000
Accounts payable	125,000
Long-term debt	400,000
Common stock	535,000
Retained earnings	1,045,000
Total liabilities and shareholders' equity	2,105,000

Income Statement for the Year ended 9/30/2008

Income Statement for the Year ended 9/30/2008

Sales	1,352,000
Cost of goods sold	(1,205,000)
Depreciation	(140,000)
Net income	7,000

Other information to be considered:

- *Exchange rates (CAD/USD)*

Fiscal 2007 (average)	1.44
Fiscal 2008 (average)	1.35
October 1, 2004	1.50
September 30, 2007	1.48
June 30, 2008	1.37
September 30, 2008	1.32

- Beginning inventory for fiscal 2008 had been purchased evenly throughout fiscal 2007. The company uses the FIFO inventory value method.
- Dividends of USD 25,000 were declared on June 30, 2008.
- All of the remaining inventory at the end of fiscal 2008 was purchased evenly throughout fiscal 2008.
- All of the PP&E was purchased, and all of the common equity was issued at the inception of the company on October 1, 2004. No new PP&E has been acquired, and no additional common stock has been issued since then. However, they plan to purchase new PP&E starting in fiscal 2009.
- The beginning retained earnings balance for fiscal 2008 was CAD 1,550,000.
- The accounts payable on the fiscal 2008 balance sheet were all incurred on June 30, 2008.
- The U.S. subsidiary's operations are highly integrated with the main operations in Canada.
- The remeasured inventory for 2008 using the temporal method is CAD 810,000.
- Costs of goods sold under the temporal method in 2008 is CAD 1,667,250.

.....

Are Hally's statements regarding foreign currency translation correct?

	Statement 1	Statement 2
A)	Yes	Yes
B)	Yes	No
C)	No	No

Question #20 of 60

Question ID: 691228

Ota L'Abbe, a supervisor at an investment research firm, has asked one of the junior analysts, Andreas Hally, to draft a research report dealing with various accounting issues.

Excerpts from the request are as follows:

- "There's an exciting company that we're starting to follow these days. It's called Snowboards and Skateboards, Inc. They are a multinational company with operations and a head office based in the resort town of Whistler in western Canada. However, they also have a significant subsidiary located in the United States."
- "Look at the subsidiary and deal with some foreign currency issues, including the specific differences between the temporal and current rate methods of translation, as well as the effect on financial ratios."
- "The attached file contains the September 30, 2008, financial statements of the U.S. subsidiary. Translate the financial statements into Canadian dollars in a manner consistent with U.S. GAAP."

The following are statements from the research report subsequently written by Hally:

Statement 1:	Subsidiaries whose operations are well-integrated with the parent will use the current rate method of translation.
Statement 2:	Self-contained, independent subsidiaries whose operating, investing, and financing activities are primarily located in the local market will use the temporal method of translation.

Snowboards and Skateboards, Inc. (U.S.)	(U.S. dollars)
Balance Sheet as of 9/30/2008	
Cash and accounts receivable	775,000
Inventory	600,000
Property, plant, and equipment (PP&E) - net	730,000
Total assets	2,105,000
Accounts payable	125,000
Long-term debt	400,000
Common stock	535,000
Retained earnings	1,045,000
Total liabilities and shareholders' equity	2,105,000
Income Statement for the Year ended 9/30/2008	
Sales	1,352,000
Cost of goods sold	(1,205,000)
Depreciation	(140,000)
Net income	7,000

Other information to be considered:

- *Exchange rates (CAD/USD)*

- *Exchange rates (CAD/USD)*

Fiscal 2007 (average)	1.44
Fiscal 2008 (average)	1.35
October 1, 2004	1.50
September 30, 2007	1.48
June 30, 2008	1.37
September 30, 2008	1.32

- Beginning inventory for fiscal 2008 had been purchased evenly throughout fiscal 2007. The company uses the FIFO inventory value method.
- Dividends of USD 25,000 were declared on June 30, 2008.
- All of the remaining inventory at the end of fiscal 2008 was purchased evenly throughout fiscal 2008.
- All of the PP&E was purchased, and all of the common equity was issued at the inception of the company on October 1, 2004. No new PP&E has been acquired, and no additional common stock has been issued since then. However, they plan to purchase new PP&E starting in fiscal 2009.
- The beginning retained earnings balance for fiscal 2008 was CAD 1,550,000.
- The accounts payable on the fiscal 2008 balance sheet were all incurred on June 30, 2008.
- The U.S. subsidiary's operations are highly integrated with the main operations in Canada.
- The remeasured inventory for 2008 using the temporal method is CAD 810,000.
- Costs of goods sold under the temporal method in 2008 is CAD 1,667,250.

.....

Which of the following *best* describes the effect on the parent's fiscal 2008 sales when translated to Canadian dollars? Sales, relative to what it would have been if the CAD/USD exchange rate had not changed, will be:

A) lower because the U.S. dollar depreciated during fiscal 2008.

B) higher because the average value of the Canadian dollar depreciated during fiscal 2008.

C) lower because the U.S. dollar appreciated during fiscal 2008.

Question #21 of 60

Question ID: 691229

Ota L'Abbe, a supervisor at an investment research firm, has asked one of the junior analysts, Andreas Hally, to draft a research report dealing with various accounting issues.

Excerpts from the request are as follows:

- "There's an exciting company that we're starting to follow these days. It's called Snowboards and Skateboards, Inc. They

are a multinational company with operations and a head office based in the resort town of Whistler in western Canada. However, they also have a significant subsidiary located in the United States."

- "Look at the subsidiary and deal with some foreign currency issues, including the specific differences between the temporal and current rate methods of translation, as well as the effect on financial ratios."
- "The attached file contains the September 30, 2008, financial statements of the U.S. subsidiary. Translate the financial statements into Canadian dollars in a manner consistent with U.S. GAAP."

The following are statements from the research report subsequently written by Hally:

Statement 1:	Subsidiaries whose operations are well-integrated with the parent will use the current rate method of translation.
Statement 2:	Self-contained, independent subsidiaries whose operating, investing, and financing activities are primarily located in the local market will use the temporal method of translation.

Snowboards and Skateboards, Inc. (U.S.)	(U.S. dollars)
Balance Sheet as of 9/30/2008	
Cash and accounts receivable	775,000
Inventory	600,000
Property, plant, and equipment (PP&E) - net	730,000
Total assets	2,105,000
Accounts payable	125,000
Long-term debt	400,000
Common stock	535,000
Retained earnings	1,045,000
Total liabilities and shareholders' equity	2,105,000
Income Statement for the Year ended 9/30/2008	
Sales	1,352,000
Cost of goods sold	(1,205,000)
Depreciation	(140,000)
Net income	7,000

Other information to be considered:

- *Exchange rates (CAD/USD)*

Fiscal 2007 (average)	1.44
Fiscal 2008 (average)	1.35
October 1, 2004	1.50
September 30, 2007	1.48
June 30, 2008	1.37
September 30, 2008	1.32

- Beginning inventory for fiscal 2008 had been purchased evenly throughout fiscal 2007. The company uses the FIFO

- Beginning inventory for fiscal 2008 had been purchased evenly throughout fiscal 2007. The company uses the FIFO inventory value method.
- Dividends of USD 25,000 were declared on June 30, 2008.
- All of the remaining inventory at the end of fiscal 2008 was purchased evenly throughout fiscal 2008.
- All of the PP&E was purchased, and all of the common equity was issued at the inception of the company on October 1, 2004. No new PP&E has been acquired, and no additional common stock has been issued since then. However, they plan to purchase new PP&E starting in fiscal 2009.
- The beginning retained earnings balance for fiscal 2008 was CAD 1,550,000.
- The accounts payable on the fiscal 2008 balance sheet were all incurred on June 30, 2008.
- The U.S. subsidiary's operations are highly integrated with the main operations in Canada.
- The remeasured inventory for 2008 using the temporal method is CAD 810,000.
- Costs of goods sold under the temporal method in 2008 is CAD 1,667,250.

.....

As compared to the temporal method, which of the following financial statement elements of the parent are lower under the current rate method?

A) Cash and accounts receivable.

B) Depreciation expense and cost of goods sold.

C) Common stock and dividends paid.

Question #22 of 60

Question ID: 692303

Ota L'Abbe, a supervisor at an investment research firm, has asked one of the junior analysts, Andreas Hally, to draft a research report dealing with various accounting issues.

Excerpts from the request are as follows:

- "There's an exciting company that we're starting to follow these days. It's called Snowboards and Skateboards, Inc. They are a multinational company with operations and a head office based in the resort town of Whistler in western Canada. However, they also have a significant subsidiary located in the United States."
- "Look at the subsidiary and deal with some foreign currency issues, including the specific differences between the temporal and current rate methods of translation, as well as the effect on financial ratios."
- "The attached file contains the September 30, 2008, financial statements of the U.S. subsidiary. Translate the financial statements into Canadian dollars in a manner consistent with U.S. GAAP."

The following are statements from the research report subsequently written by Hally:

Statement 1:	Subsidiaries whose operations are well-integrated with the parent will use the current rate method of translation.

Statement 2: Self-contained, independent subsidiaries whose operating, investing, and financing activities are primarily located in the local market will use the temporal method of translation.

Snowboards and Skateboards, Inc. (U.S.)	(U.S. dollars)
Balance Sheet as of 9/30/2008	
Cash and accounts receivable	775,000
Inventory	600,000
Property, plant, and equipment (PP&E) - net	730,000
Total assets	2,105,000
Accounts payable	125,000
Long-term debt	400,000
Common stock	535,000
Retained earnings	1,045,000
Total liabilities and shareholders' equity	2,105,000
Income Statement for the Year ended 9/30/2008	
Sales	1,352,000
Cost of goods sold	(1,205,000)
Depreciation	(140,000)
Net income	7,000

Other information to be considered:

- *Exchange rates (CAD/USD)*

Fiscal 2007 (average)	1.44
Fiscal 2008 (average)	1.35
October 1, 2004	1.50
September 30, 2007	1.48
June 30, 2008	1.37
September 30, 2008	1.32

- Beginning inventory for fiscal 2008 had been purchased evenly throughout fiscal 2007. The company uses the FIFO inventory value method.
- Dividends of USD 25,000 were declared on June 30, 2008.
- All of the remaining inventory at the end of fiscal 2008 was purchased evenly throughout fiscal 2008.
- All of the PP&E was purchased, and all of the common equity was issued at the inception of the company on October 1, 2004. No new PP&E has been acquired, and no additional common stock has been issued since then. However, they plan to purchase new PP&E starting in fiscal 2009.
- The beginning retained earnings balance for fiscal 2008 was CAD 1,550,000.

- The accounts payable on the fiscal 2008 balance sheet were all incurred on June 30, 2008.
- The U.S. subsidiary's operations are highly integrated with the main operations in Canada.
- The remeasured inventory for 2008 using the temporal method is CAD 810,000.
- Costs of goods sold under the temporal method in 2008 is CAD 1,667,250.

.....

Using the appropriate translation method, which of the following *best* describes the effect of changing exchange rates on the parent's fiscal 2008 financial statements?

A) An accumulated loss of CAD 242,100 is reported in the shareholders' equity.

B) A loss of CAD 31,200 is recognized in the income statement.

C) A gain of CAD 27,400 is recognized in the income statement.

Question #23 of 60

Question ID: 691231

Ota L'Abbe, a supervisor at an investment research firm, has asked one of the junior analysts, Andreas Hally, to draft a research report dealing with various accounting issues.

Excerpts from the request are as follows:

- "There's an exciting company that we're starting to follow these days. It's called Snowboards and Skateboards, Inc. They are a multinational company with operations and a head office based in the resort town of Whistler in western Canada. However, they also have a significant subsidiary located in the United States."
- "Look at the subsidiary and deal with some foreign currency issues, including the specific differences between the temporal and current rate methods of translation, as well as the effect on financial ratios."
- "The attached file contains the September 30, 2008, financial statements of the U.S. subsidiary. Translate the financial statements into Canadian dollars in a manner consistent with U.S. GAAP."

The following are statements from the research report subsequently written by Hally:

Statement 1:	Subsidiaries whose operations are well-integrated with the parent will use the current rate method of translation.
Statement 2:	Self-contained, independent subsidiaries whose operating, investing, and financing activities are primarily located in the local market will use the temporal method of translation.

Snowboards and Skateboards, Inc. (U.S.)	(U.S. dollars)
Balance Sheet as of 9/30/2008	
Cash and accounts receivable	775,000
Inventory	600,000
Property, plant, and equipment (PP&E) - net	730,000
Total assets	2,105,000

Total assets	2,105,000
Accounts payable	125,000
Long-term debt	400,000
Common stock	535,000
Retained earnings	1,045,000
Total liabilities and shareholders' equity	2,105,000
Income Statement for the Year ended 9/30/2008	
Sales	1,352,000
Cost of goods sold	(1,205,000)
Depreciation	(140,000)
Net income	7,000

Other information to be considered:

- *Exchange rates (CAD/USD)*

Fiscal 2007 (average)	1.44
Fiscal 2008 (average)	1.35
October 1, 2004	1.50
September 30, 2007	1.48
June 30, 2008	1.37
September 30, 2008	1.32

- Beginning inventory for fiscal 2008 had been purchased evenly throughout fiscal 2007. The company uses the FIFO inventory value method.
- Dividends of USD 25,000 were declared on June 30, 2008.
- All of the remaining inventory at the end of fiscal 2008 was purchased evenly throughout fiscal 2008.
- All of the PP&E was purchased, and all of the common equity was issued at the inception of the company on October 1, 2004. No new PP&E has been acquired, and no additional common stock has been issued since then. However, they plan to purchase new PP&E starting in fiscal 2009.
- The beginning retained earnings balance for fiscal 2008 was CAD 1,550,000.
- The accounts payable on the fiscal 2008 balance sheet were all incurred on June 30, 2008.
- The U.S. subsidiary's operations are highly integrated with the main operations in Canada.
- The remeasured inventory for 2008 using the temporal method is CAD 810,000.
- Costs of goods sold under the temporal method in 2008 is CAD 1,667,250.

.....

As compared to the temporal method, the parent's fixed asset turnover for fiscal 2008 using the current rate method is:

A) higher.

B) lower.

C) the same.

Question #24 of 60

Question ID: 691232

Ota L'Abbe, a supervisor at an investment research firm, has asked one of the junior analysts, Andreas Hally, to draft a research report dealing with various accounting issues.

Excerpts from the request are as follows:

- "There's an exciting company that we're starting to follow these days. It's called Snowboards and Skateboards, Inc. They are a multinational company with operations and a head office based in the resort town of Whistler in western Canada. However, they also have a significant subsidiary located in the United States."
- "Look at the subsidiary and deal with some foreign currency issues, including the specific differences between the temporal and current rate methods of translation, as well as the effect on financial ratios."
- "The attached file contains the September 30, 2008, financial statements of the U.S. subsidiary. Translate the financial statements into Canadian dollars in a manner consistent with U.S. GAAP."

The following are statements from the research report subsequently written by Hally:

Statement 1:	Subsidiaries whose operations are well-integrated with the parent will use the current rate method of translation.
Statement 2:	Self-contained, independent subsidiaries whose operating, investing, and financing activities are primarily located in the local market will use the temporal method of translation.

Snowboards and Skateboards, Inc. (U.S.)	(U.S. dollars)
Balance Sheet as of 9/30/2008	
Cash and accounts receivable	775,000
Inventory	600,000
Property, plant, and equipment (PP&E) - net	730,000
Total assets	2,105,000
Accounts payable	125,000
Long-term debt	400,000
Common stock	535,000
Retained earnings	1,045,000
Total liabilities and shareholders' equity	2,105,000
Income Statement for the Year ended 9/30/2008	
Sales	1,352,000
Cost of goods sold	(1,205,000)
Depreciation	(140,000)

Net income	7,000

Other information to be considered:

- *Exchange rates (CAD/USD)*

Fiscal 2007 (average)	1.44
Fiscal 2008 (average)	1.35
October 1, 2004	1.50
September 30, 2007	1.48
June 30, 2008	1.37
September 30, 2008	1.32

- Beginning inventory for fiscal 2008 had been purchased evenly throughout fiscal 2007. The company uses the FIFO inventory value method.
- Dividends of USD 25,000 were declared on June 30, 2008.
- All of the remaining inventory at the end of fiscal 2008 was purchased evenly throughout fiscal 2008.
- All of the PP&E was purchased, and all of the common equity was issued at the inception of the company on October 1, 2004. No new PP&E has been acquired, and no additional common stock has been issued since then. However, they plan to purchase new PP&E starting in fiscal 2009.
- The beginning retained earnings balance for fiscal 2008 was CAD 1,550,000.
- The accounts payable on the fiscal 2008 balance sheet were all incurred on June 30, 2008.
- The U.S. subsidiary's operations are highly integrated with the main operations in Canada.
- The remeasured inventory for 2008 using the temporal method is CAD 810,000.
- Costs of goods sold under the temporal method in 2008 is CAD 1,667,250.

.....

Suppose the parent uses the current rate method to translate the subsidiary for fiscal 2008. Will return on assets and net profit margin in U.S. dollars before translation be the same as, or different than, the translated Canadian dollar ratios?

	Return on assets	Net profit margin
A)	Same	Different
B)	Different	Different
C)	Different	Same

Question #25 of 60

Question ID: 692302

Questions 25-30 relate to Wayland, Inc., and Optimax.

Kevin Rathbun, CFA, is a financial analyst at a major brokerage firm. His supervisor, Elizabeth Mao, CFA, asks him to analyze the financial position of Wayland, Inc. (Wayland), a manufacturer of components for high quality optic transmission systems. Mao also inquires about the impact of any unconsolidated investments.

On December 31, 2007, Wayland purchased a 35% ownership interest in a strategic new firm called Optimax for $300,000 cash. The pre-acquisition balance sheets of both firms are found in Exhibit 1.

Exhibit 1: Pre-Acquisition Balance Sheets for Wayland and Optimax

Balance sheets as of Dec. 31, 2007 *in thousands*	**Wayland**	**Optimax**
Assets		
Cash	$710	$100
Marketable securities	2,550	-
Inventory	2,000	400
Accounts receivable	3,000	500
Property, plant, and equipment	2,450	1,000
Total assets	**$10,710**	**$2,000**
Liabilities		
Accounts payable	$3,310	400
Long-term debt	5,000	1,000
Equity	2,400	600
Total liabilities and equity	**$10,710**	**$2,000**

On the acquisition date, all of Optimax's assets and liabilities were stated on its balance sheet at their fair values except for its property, plant, and equipment (PP&E), which had a fair value of $1.2 million. The remaining useful life of the PP&E is ten years with no salvage value. Both firms use the straight-line depreciation method.

For the year ended 2008, Optimax reported net income of $250,000 and paid dividends of $100,000.

During the first quarter of 2009, Optimax sold goods to Wayland and recognized $15,000 of profit from the sale. At the end of the quarter, half of the goods purchased from Optimax remained in Wayland's inventory.

Wayland currently uses the equity method to account for its investment in Optimax.

Rathbun also notes that Wayland owns shares in Vanry, Inc. (Vanry). Rathbun gathers the data in Exhibit 2 from Wayland's financial statements. The year-end portfolio value is the market value of all Vanry shares held on December 31. All security transactions occurred on July 1, and the transaction price is the price that Wayland actually paid for the shares acquired. Vanry pays a cash dividend of $1 per share at the end of each year. Wayland expects to sell its investment in Vanry in the near term and accounts for it as *held-for-trading*.

Exhibit 2: Share Transaction Data, Vanry, Inc.

	Year-End

Year	*Year-End Portfolio Value*	*Year-End Shares Held*	*Year-End Share Price*	*Transaction Price (July 1)*
2007	$1,875,000	25,000[a]	$75	$85
2008	$2,280,000	30,000	76	78

[a]Purchased on July 1, 2007.

Wayland owns some publicly traded bonds of the Rotor Corporation that it reports as held-to-maturity securities.

.....

The amount of goodwill as a result of Wayland's acquisition of Optimax is *closest* to:

A) $0.

B) $20,000.

C) $50,000.

Question #26 of 60

Question ID: 691880

Kevin Rathbun, CFA, is a financial analyst at a major brokerage firm. His supervisor, Elizabeth Mao, CFA, asks him to analyze the financial position of Wayland, Inc. (Wayland), a manufacturer of components for high quality optic transmission systems. Mao also inquires about the impact of any unconsolidated investments.

On December 31, 2007, Wayland purchased a 35% ownership interest in a strategic new firm called Optimax for $300,000 cash. The pre-acquisition balance sheets of both firms are found in Exhibit 1.

Exhibit 1: Pre-Acquisition Balance Sheets for Wayland and Optimax

Balance sheets as of Dec. 31, 2007 *in thousands*	**Wayland**	**Optimax**
Assets		
Cash	$710	$100
Marketable securities	2,550	-
Inventory	2,000	400
Accounts receivable	3,000	500
Property, plant, and equipment	2,450	1,000
Total assets	**$10,710**	**$2,000**
Liabilities		
Accounts payable	$3,310	400
Long-term debt	5,000	1,000
Equity	2,400	600
Total liabilities and equity	**$10,710**	**$2,000**

Total liabilities and equity $10,740 $2,000

On the acquisition date, all of Optimax's assets and liabilities were stated on its balance sheet at their fair values except for its property, plant, and equipment (PP&E), which had a fair value of $1.2 million. The remaining useful life of the PP&E is ten years with no salvage value. Both firms use the straight-line depreciation method.

For the year ended 2008, Optimax reported net income of $250,000 and paid dividends of $100,000.

During the first quarter of 2009, Optimax sold goods to Wayland and recognized $15,000 of profit from the sale. At the end of the quarter, half of the goods purchased from Optimax remained in Wayland's inventory.

Wayland currently uses the equity method to account for its investment in Optimax.

Rathbun also notes that Wayland owns shares in Vanry, Inc. (Vanry). Rathbun gathers the data in Exhibit 2 from Wayland's financial statements. The year-end portfolio value is the market value of all Vanry shares held on December 31. All security transactions occurred on July 1, and the transaction price is the price that Wayland actually paid for the shares acquired. Vanry pays a cash dividend of $1 per share at the end of each year. Wayland expects to sell its investment in Vanry in the near term and accounts for it as *held-for-trading*.

Exhibit 2: Share Transaction Data, Vanry, Inc.

Year	*Year-End Portfolio Value*	*Year-End Shares Held*	*Year-End Share Price*	*Transaction Price (July 1)*
2007	$1,875,000	25,000[a]	$75	$85
2008	$2,280,000	30,000	76	78

[a]Purchased on July 1, 2007.

Wayland owns some publicly traded bonds of the Rotor Corporation that it reports as held-to-maturity securities.

.....

What amount should Wayland report in its balance sheet as a result of its investment in Optimax at the end of 2008?

A) $352,000.

B) $345,500.

C) $380,500.

Question #27 of 60

Question ID: 691881

Kevin Rathbun, CFA, is a financial analyst at a major brokerage firm. His supervisor, Elizabeth Mao, CFA, asks him to analyze the financial position of Wayland, Inc. (Wayland), a manufacturer of components for high quality optic transmission systems. Mao also inquires about the impact of any unconsolidated investments.

On December 31, 2007, Wayland purchased a 35% ownership interest in a strategic new firm called Optimax for $300,000 cash. The pre-acquisition balance sheets of both firms are found in Exhibit 1.

Exhibit 1: Pre-Acquisition Balance Sheets for Wayland and Optimax

Exhibit 1: Pre-Acquisition Balance Sheets for Wayland and Optimax

Balance sheets as of Dec. 31, 2007 *in thousands*	**Wayland**	**Optimax**
Assets		
Cash	$710	$100
Marketable securities	2,550	-
Inventory	2,000	400
Accounts receivable	3,000	500
Property, plant, and equipment	2,450	1,000
Total assets	**$10,710**	**$2,000**
Liabilities		
Accounts payable	$3,310	400
Long-term debt	5,000	1,000
Equity	2,400	600
Total liabilities and equity	**$10,710**	**$2,000**

On the acquisition date, all of Optimax's assets and liabilities were stated on its balance sheet at their fair values except for its property, plant, and equipment (PP&E), which had a fair value of $1.2 million. The remaining useful life of the PP&E is ten years with no salvage value. Both firms use the straight-line depreciation method.

For the year ended 2008, Optimax reported net income of $250,000 and paid dividends of $100,000.

During the first quarter of 2009, Optimax sold goods to Wayland and recognized $15,000 of profit from the sale. At the end of the quarter, half of the goods purchased from Optimax remained in Wayland's inventory.

Wayland currently uses the equity method to account for its investment in Optimax.

Rathbun also notes that Wayland owns shares in Vanry, Inc. (Vanry). Rathbun gathers the data in Exhibit 2 from Wayland's financial statements. The year-end portfolio value is the market value of all Vanry shares held on December 31. All security transactions occurred on July 1, and the transaction price is the price that Wayland actually paid for the shares acquired. Vanry pays a cash dividend of $1 per share at the end of each year. Wayland expects to sell its investment in Vanry in the near term and accounts for it as *held-for-trading*.

Exhibit 2: Share Transaction Data, Vanry, Inc.

Year	*Year-End Portfolio Value*	*Year-End Shares Held*	*Year-End Share Price*	*Transaction Price (July 1)*
2007	$1,875,000	25,000[a]	$75	$85
2008	$2,280,000	30,000	76	78

[a]Purchased on July 1, 2007.

Wayland owns some publicly traded bonds of the Rotor Corporation that it reports as held-to-maturity securities.

.....

Which of the following *best* describes Wayland's treatment of the intercompany sales transaction for the quarter ended March 31, 2009? Wayland should reduce its equity income by:

A) $2,625.

B) $7,500.

C) $15,000.

Question #28 of 60

Question ID: 691877

Kevin Rathbun, CFA, is a financial analyst at a major brokerage firm. His supervisor, Elizabeth Mao, CFA, asks him to analyze the financial position of Wayland, Inc. (Wayland), a manufacturer of components for high quality optic transmission systems. Mao also inquires about the impact of any unconsolidated investments.

On December 31, 2007, Wayland purchased a 35% ownership interest in a strategic new firm called Optimax for $300,000 cash. The pre-acquisition balance sheets of both firms are found in Exhibit 1.

Exhibit 1: Pre-Acquisition Balance Sheets for Wayland and Optimax

Balance sheets as of Dec. 31, 2007 *in thousands*	**Wayland**	**Optimax**
Assets		
Cash	$710	$100
Marketable securities	2,550	-
Inventory	2,000	400
Accounts receivable	3,000	500
Property, plant, and equipment	2,450	1,000
Total assets	**$10,710**	**$2,000**
Liabilities		
Accounts payable	$3,310	400
Long-term debt	5,000	1,000
Equity	2,400	600
Total liabilities and equity	**$10,710**	**$2,000**

On the acquisition date, all of Optimax's assets and liabilities were stated on its balance sheet at their fair values except for its property, plant, and equipment (PP&E), which had a fair value of $1.2 million. The remaining useful life of the PP&E is ten years with no salvage value. Both firms use the straight-line depreciation method.

For the year ended 2008, Optimax reported net income of $250,000 and paid dividends of $100,000.

During the first quarter of 2009, Optimax sold goods to Wayland and recognized $15,000 of profit from the sale. At the end of the quarter, half of the goods purchased from Optimax remained in Wayland's inventory.

Wayland currently uses the equity method to account for its investment in Optimax.

Rathbun also notes that Wayland owns shares in Vanry, Inc. (Vanry). Rathbun gathers the data in Exhibit 2 from Wayland's financial statements. The year-end portfolio value is the market value of all Vanry shares held on December 31. All security transactions occurred on July 1, and the transaction price is the price that Wayland actually paid for the shares acquired. Vanry pays a cash dividend of $1 per share at the end of each year. Wayland expects to sell its investment in Vanry in the near term and accounts for it as *held-for-trading*.

Exhibit 2: Share Transaction Data, Vanry, Inc.

Year	*Year-End Portfolio Value*	*Year-End Shares Held*	*Year-End Share Price*	*Transaction Price (July 1)*
2007	$1,875,000	25,000[a]	$75	$85
2008	$2,280,000	30,000	76	78

[a]Purchased on July 1, 2007.

Wayland owns some publicly traded bonds of the Rotor Corporation that it reports as held-to-maturity securities.

.....

Which of the following statements is *least accurate* under the new IFRS standards (IFRS 9)?

A) Equity investments held for trading must be measured at fair value through profit or loss.

B) Equity investments once measured as fair value through OCI cannot be reclassified to be measured as fair value through profit or loss.

C) Debt securities that meet the business model test and the cash flow characteristic test must be measured at amortized cost.

Question #29 of 60

Question ID: 691878

Kevin Rathbun, CFA, is a financial analyst at a major brokerage firm. His supervisor, Elizabeth Mao, CFA, asks him to analyze the financial position of Wayland, Inc. (Wayland), a manufacturer of components for high quality optic transmission systems. Mao also inquires about the impact of any unconsolidated investments.

On December 31, 2007, Wayland purchased a 35% ownership interest in a strategic new firm called Optimax for $300,000 cash. The pre-acquisition balance sheets of both firms are found in Exhibit 1.

Exhibit 1: Pre-Acquisition Balance Sheets for Wayland and Optimax

Balance sheets as of Dec. 31, 2007 *in thousands*	**Wayland**	**Optimax**
Assets		
Cash	$710	$100
Marketable securities	2,550	-

Inventory	2,000	400
Accounts receivable	3,000	500
Property, plant, and equipment	2,450	1,000
Total assets	**$10,710**	**$2,000**
Liabilities		
Accounts payable	$3,310	400
Long-term debt	5,000	1,000
Equity	2,400	600
Total liabilities and equity	**$10,710**	**$2,000**

On the acquisition date, all of Optimax's assets and liabilities were stated on its balance sheet at their fair values except for its property, plant, and equipment (PP&E), which had a fair value of $1.2 million. The remaining useful life of the PP&E is ten years with no salvage value. Both firms use the straight-line depreciation method.

For the year ended 2008, Optimax reported net income of $250,000 and paid dividends of $100,000.

During the first quarter of 2009, Optimax sold goods to Wayland and recognized $15,000 of profit from the sale. At the end of the quarter, half of the goods purchased from Optimax remained in Wayland's inventory.

Wayland currently uses the equity method to account for its investment in Optimax.

Rathbun also notes that Wayland owns shares in Vanry, Inc. (Vanry). Rathbun gathers the data in Exhibit 2 from Wayland's financial statements. The year-end portfolio value is the market value of all Vanry shares held on December 31. All security transactions occurred on July 1, and the transaction price is the price that Wayland actually paid for the shares acquired. Vanry pays a cash dividend of $1 per share at the end of each year. Wayland expects to sell its investment in Vanry in the near term and accounts for it as *held-for-trading*.

Exhibit 2: Share Transaction Data, Vanry, Inc.

Year	*Year-End Portfolio Value*	*Year-End Shares Held*	*Year-End Share Price*	*Transaction Price (July 1)*
2007	$1,875,000	25,000[a]	$75	$85
2008	$2,280,000	30,000	76	78

[a]Purchased on July 1, 2007.

Wayland owns some publicly traded bonds of the Rotor Corporation that it reports as held-to-maturity securities.

.....

Regarding the Rotor Corporation bonds, under the current standards, Wayland would have the option to reclassify them as designated at fair value from held-to-maturity under:

A) U.S. GAAP only.

B) IFRS only.

C) both IFRS and U.S. GAAP.

Question #30 of 60

Question ID: 691879

Kevin Rathbun, CFA, is a financial analyst at a major brokerage firm. His supervisor, Elizabeth Mao, CFA, asks him to analyze the financial position of Wayland, Inc. (Wayland), a manufacturer of components for high quality optic transmission systems. Mao also inquires about the impact of any unconsolidated investments.

On December 31, 2007, Wayland purchased a 35% ownership interest in a strategic new firm called Optimax for $300,000 cash. The pre-acquisition balance sheets of both firms are found in Exhibit 1.

Exhibit 1: Pre-Acquisition Balance Sheets for Wayland and Optimax

Balance sheets as of Dec. 31, 2007 *in thousands*	**Wayland**	**Optimax**
Assets		
Cash	$710	$100
Marketable securities	2,550	-
Inventory	2,000	400
Accounts receivable	3,000	500
Property, plant, and equipment	2,450	1,000
Total assets	**$10,710**	**$2,000**
Liabilities		
Accounts payable	$3,310	400
Long-term debt	5,000	1,000
Equity	2,400	600
Total liabilities and equity	**$10,710**	**$2,000**

On the acquisition date, all of Optimax's assets and liabilities were stated on its balance sheet at their fair values except for its property, plant, and equipment (PP&E), which had a fair value of $1.2 million. The remaining useful life of the PP&E is ten years with no salvage value. Both firms use the straight-line depreciation method.

For the year ended 2008, Optimax reported net income of $250,000 and paid dividends of $100,000.

During the first quarter of 2009, Optimax sold goods to Wayland and recognized $15,000 of profit from the sale. At the end of the quarter, half of the goods purchased from Optimax remained in Wayland's inventory.

Wayland currently uses the equity method to account for its investment in Optimax.

Rathbun also notes that Wayland owns shares in Vanry, Inc. (Vanry). Rathbun gathers the data in Exhibit 2 from Wayland's financial statements. The year-end portfolio value is the market value of all Vanry shares held on December 31. All security transactions occurred on July 1, and the transaction price is the price that Wayland actually paid for the shares acquired. Vanry pays a cash dividend of $1 per share at the end of each year. Wayland expects to sell its investment in Vanry in the near term and accounts for it as *held-for-trading*.

Exhibit 2: Share Transaction Data, Year 1

Exhibit 2: Share Transaction Data, Vanry, Inc.

Year	*Year-End Portfolio Value*	*Year-End Shares Held*	*Year-End Share Price*	*Transaction Price (July 1)*
2007	$1,875,000	25,000[a]	$75	$85
2008	$2,280,000	30,000	76	78

[a]Purchased on July 1, 2007.

Wayland owns some publicly traded bonds of the Rotor Corporation that it reports as held-to-maturity securities.

.....

As a result of its investment in Vanry, what amount should Wayland recognize in its income statement for the year ended 2008?

A) $35,000 profit.

B) $45,000 profit.

C) $55,000 profit.

Question #31 of 60

Question ID: 691893

Questions 31-36 relate to Lorenz Kummert.

Lorenz Kummert is a junior equity analyst who is following Schubert, Inc. (Schubert), a small publicly traded company in the United States. His supervisor, Markus Alter, CFA, has advised him to use the residual income model to analyze Schubert.

In his preliminary report to Alter, Kummert makes the following statements:

Statement 1: Residual income models are appropriate when expected free cash flows are negative for the foreseeable future.

Statement 2: Residual income models are not applicable when dividends are volatile.

Kummert has determined Schubert's cost of equity, cost of debt, and weighted average cost of capital (WACC) to be 12.8%, 8.4%, and 11.9%, respectively. Book value of long-term debt and equity was $6,200,000 and $3,281,000 respectively on January 1, 2008. The stock price on December 31, 2008, is $36 per share and there are 130,000 shares outstanding. The relevant tax rate is 30%, and return on equity (ROE) is expected to be 14%.

Summarized financial information about Schubert for 2008 is provided in Exhibits 1 and 2.

Exhibit 1: Schubert, Inc., Balance Sheet on December 31, 2008

Cash	$ 125,000	Accounts payable	$ 426,000
Accounts receivable	975,000	Accrued liabilities	774,000
Inventory	1,215,000	Long-term debt	6,211,000
Fixed assets (net)	9,277,000		
		Common shares	2,100,000

		Retained earnings	2,081,000
Total assets	$11,592,000	Total liabilities and equity	$11,592,000

Exhibit 2: Schubert, Inc., Income Statement for the year ended December 31, 2008

Sales	$9,423,000
Cost of sales	4,580,000
Selling, general, and administrative	1,230,000
Depreciation	1,745,000
Interest expense	522,000
Income tax expense	403,800
Net income	$942,200

Based on his analysis of several years of financial statements, Kummert notes that 2008 was an exceptionally profitable year for Schubert, and that its dividend payouts are usually low because the funds are mainly reinvested in the firm to promote growth. Furthermore, there are very few nonrecurring items on the income statement. Upon review of Kummert's preliminary report, Alter concurs with his analysis of the financial statements but reminds him that Schubert's long-term debt is currently trading at 95% of its book value. He also cautions Kummert that violations of the clean surplus relation can bias the results of the residual income model.

The consensus annual EPS estimate for 2009 is $4.50, and the dividend payout ratio for 2009 is estimated at 5%.

.....

Are Kummert's statements regarding the residual income model correct?

A) Both statements are incorrect.

B) Only Statement 1 is correct.

C) Only Statement 2 is correct.

Question #32 of 60

Question ID: 691892

Lorenz Kummert is a junior equity analyst who is following Schubert, Inc. (Schubert), a small publicly traded company in the United States. His supervisor, Markus Alter, CFA, has advised him to use the residual income model to analyze Schubert.

In his preliminary report to Alter, Kummert makes the following statements:

Statement 1:	Residual income models are appropriate when expected free cash flows are negative for the foreseeable future.
Statement 2:	Residual income models are not applicable when dividends are volatile.

Kummert has determined Schubert's cost of equity, cost of debt, and weighted average cost of capital (WACC) to be 12.8%, 8.4%, and 11.9%, respectively. Book value of long-term debt and equity was $6,200,000 and $3,281,000 respectively on

8.4%, and 11.9%, respectively. Book value of long-term debt and equity was $6,200,000 and $3,281,000 respectively on January 1, 2008. The stock price on December 31, 2008, is $36 per share and there are 130,000 shares outstanding. The relevant tax rate is 30%, and return on equity (ROE) is expected to be 14%.

Summarized financial information about Schubert for 2008 is provided in Exhibits 1 and 2.

Exhibit 1: Schubert, Inc., Balance Sheet on December 31, 2008

Cash	$ 125,000	Accounts payable	$ 426,000
Accounts receivable	975,000	Accrued liabilities	774,000
Inventory	1,215,000	Long-term debt	6,211,000
Fixed assets (net)	9,277,000		
		Common shares	2,100,000
		Retained earnings	2,081,000
Total assets	$11,592,000	Total liabilities and equity	$11,592,000

Exhibit 2: Schubert, Inc., Income Statement for the year ended December 31, 2008

Sales	$9,423,000
Cost of sales	4,580,000
Selling, general, and administrative	1,230,000
Depreciation	1,745,000
Interest expense	522,000
Income tax expense	403,800
Net income	$942,200

Based on his analysis of several years of financial statements, Kummert notes that 2008 was an exceptionally profitable year for Schubert, and that its dividend payouts are usually low because the funds are mainly reinvested in the firm to promote growth. Furthermore, there are very few nonrecurring items on the income statement. Upon review of Kummert's preliminary report, Alter concurs with his analysis of the financial statements but reminds him that Schubert's long-term debt is currently trading at 95% of its book value. He also cautions Kummert that violations of the clean surplus relation can bias the results of the residual income model.

The consensus annual EPS estimate for 2009 is $4.50, and the dividend payout ratio for 2009 is estimated at 5%.

.....

Assuming that Kummert and Alter are correct with their conclusions regarding Schubert's financial statements, which of the following levels would *best* describe the strength of the persistence factor with respect to Schubert's residual income?

A) Low persistence factor.

B) Medium persistence factor.

C) High persistence factor.

Question #33 of 60

Question ID: 691890

Lorenz Kummert is a junior equity analyst who is following Schubert, Inc. (Schubert), a small publicly traded company in the United States. His supervisor, Markus Alter, CFA, has advised him to use the residual income model to analyze Schubert.

In his preliminary report to Alter, Kummert makes the following statements:

Statement 1: Residual income models are appropriate when expected free cash flows are negative for the foreseeable future.

Statement 2: Residual income models are not applicable when dividends are volatile.

Kummert has determined Schubert's cost of equity, cost of debt, and weighted average cost of capital (WACC) to be 12.8%, 8.4%, and 11.9%, respectively. Book value of long-term debt and equity was $6,200,000 and $3,281,000 respectively on January 1, 2008. The stock price on December 31, 2008, is $36 per share and there are 130,000 shares outstanding. The relevant tax rate is 30%, and return on equity (ROE) is expected to be 14%.

Summarized financial information about Schubert for 2008 is provided in Exhibits 1 and 2.

Exhibit 1: Schubert, Inc., Balance Sheet on December 31, 2008

Cash	$ 125,000	Accounts payable	$ 426,000
Accounts receivable	975,000	Accrued liabilities	774,000
Inventory	1,215,000	Long-term debt	6,211,000
Fixed assets (net)	9,277,000		
		Common shares	2,100,000
		Retained earnings	2,081,000
Total assets	$11,592,000	Total liabilities and equity	$11,592,000

Exhibit 2: Schubert, Inc., Income Statement for the year ended December 31, 2008

Sales	$9,423,000
Cost of sales	4,580,000
Selling, general, and administrative	1,230,000
Depreciation	1,745,000
Interest expense	522,000
Income tax expense	403,800
Net income	$942,200

Based on his analysis of several years of financial statements, Kummert notes that 2008 was an exceptionally profitable year for Schubert, and that its dividend payouts are usually low because the funds are mainly reinvested in the firm to promote growth. Furthermore, there are very few nonrecurring items on the income statement. Upon review of Kummert's preliminary report, Alter concurs with his analysis of the financial statements but reminds him that Schubert's long-term debt is currently trading at 95% of its book value. He also cautions Kummert that violations of the clean surplus relation can bias the results of the residual income model.

The consensus annual EPS estimate for 2009 is $4.50, and the dividend payout ratio for 2009 is estimated at 5%.

.....

Which of the following amounts is *closest* to the forecast of Schubert's book value per share and residual income, respectively,

for 2009?

	Book value per share	Residual income
A)	$36.43	$0.38
B)	$38.00	$2.32
C)	$36.40	$2.32

Question #34 of 60

Question ID: 691889

Lorenz Kummert is a junior equity analyst who is following Schubert, Inc. (Schubert), a small publicly traded company in the United States. His supervisor, Markus Alter, CFA, has advised him to use the residual income model to analyze Schubert.

In his preliminary report to Alter, Kummert makes the following statements:

Statement 1: Residual income models are appropriate when expected free cash flows are negative for the foreseeable future.

Statement 2: Residual income models are not applicable when dividends are volatile.

Kummert has determined Schubert's cost of equity, cost of debt, and weighted average cost of capital (WACC) to be 12.8%, 8.4%, and 11.9%, respectively. Book value of long-term debt and equity was $6,200,000 and $3,281,000 respectively on January 1, 2008. The stock price on December 31, 2008, is $36 per share and there are 130,000 shares outstanding. The relevant tax rate is 30%, and return on equity (ROE) is expected to be 14%.

Summarized financial information about Schubert for 2008 is provided in Exhibits 1 and 2.

Exhibit 1: Schubert, Inc., Balance Sheet on December 31, 2008

Cash	$ 125,000	Accounts payable	$ 426,000
Accounts receivable	975,000	Accrued liabilities	774,000
Inventory	1,215,000	Long-term debt	6,211,000
Fixed assets (net)	9,277,000		
		Common shares	2,100,000
		Retained earnings	2,081,000
Total assets	$11,592,000	Total liabilities and equity	$11,592,000

Exhibit 2: Schubert, Inc., Income Statement for the year ended December 31, 2008

Sales	$9,423,000
Cost of sales	4,580,000
Selling, general, and administrative	1,230,000
Depreciation	1,745,000
Interest expense	533,000

Interest expense	522,000
Income tax expense	403,800
Net income	$942,200

Based on his analysis of several years of financial statements, Kummert notes that 2008 was an exceptionally profitable year for Schubert, and that its dividend payouts are usually low because the funds are mainly reinvested in the firm to promote growth. Furthermore, there are very few nonrecurring items on the income statement. Upon review of Kummert's preliminary report, Alter concurs with his analysis of the financial statements but reminds him that Schubert's long-term debt is currently trading at 95% of its book value. He also cautions Kummert that violations of the clean surplus relation can bias the results of the residual income model.

The consensus annual EPS estimate for 2009 is $4.50, and the dividend payout ratio for 2009 is estimated at 5%.

.....

Which of the following amounts are *closest* to Schubert's economic value added (EVA) for fiscal year 2008 and market value added (MVA) as of fiscal year-end 2008, respectively?

	EVA	MVA
A)	$179,361	$188,450
B)	$23,455	$369,500
C)	($70,900)	$369,500

Question #35 of 60

Question ID: 691891

Lorenz Kummert is a junior equity analyst who is following Schubert, Inc. (Schubert), a small publicly traded company in the United States. His supervisor, Markus Alter, CFA, has advised him to use the residual income model to analyze Schubert.

In his preliminary report to Alter, Kummert makes the following statements:

Statement 1: Residual income models are appropriate when expected free cash flows are negative for the foreseeable future.

Statement 2: Residual income models are not applicable when dividends are volatile.

Kummert has determined Schubert's cost of equity, cost of debt, and weighted average cost of capital (WACC) to be 12.8%, 8.4%, and 11.9%, respectively. Book value of long-term debt and equity was $6,200,000 and $3,281,000 respectively on January 1, 2008. The stock price on December 31, 2008, is $36 per share and there are 130,000 shares outstanding. The relevant tax rate is 30%, and return on equity (ROE) is expected to be 14%.

Summarized financial information about Schubert for 2008 is provided in Exhibits 1 and 2.

Exhibit 1: Schubert, Inc., Balance Sheet on December 31, 2008

Cash	$ 125,000	Accounts payable	$ 426,000
Accounts receivable	975,000	Accrued liabilities	774,000

Inventory	1,215,000	Long-term debt	6,211,000
Fixed assets (net)	9,277,000		
		Common shares	2,100,000
		Retained earnings	2,081,000
Total assets	$11,592,000	Total liabilities and equity	$11,592,000

Exhibit 2: Schubert, Inc., Income Statement for the year ended December 31, 2008

Sales	$9,423,000
Cost of sales	4,580,000
Selling, general, and administrative	1,230,000
Depreciation	1,745,000
Interest expense	522,000
Income tax expense	403,800
Net income	$942,200

Based on his analysis of several years of financial statements, Kummert notes that 2008 was an exceptionally profitable year for Schubert, and that its dividend payouts are usually low because the funds are mainly reinvested in the firm to promote growth. Furthermore, there are very few nonrecurring items on the income statement. Upon review of Kummert's preliminary report, Alter concurs with his analysis of the financial statements but reminds him that Schubert's long-term debt is currently trading at 95% of its book value. He also cautions Kummert that violations of the clean surplus relation can bias the results of the residual income model.

The consensus annual EPS estimate for 2009 is $4.50, and the dividend payout ratio for 2009 is estimated at 5%.

.....

Which of the following amounts is *closest* to Schubert's implied growth rate in residual income?

A) 0.34%.

B) 2.75%.

C) 12.63%.

Question #36 of 60

Question ID: 691894

Lorenz Kummert is a junior equity analyst who is following Schubert, Inc. (Schubert), a small publicly traded company in the United States. His supervisor, Markus Alter, CFA, has advised him to use the residual income model to analyze Schubert.

In his preliminary report to Alter, Kummert makes the following statements:

Statement 1: Residual income models are appropriate when expected free cash flows are negative for the foreseeable future.

Statement 2: Residual income models are not applicable when dividends are volatile.

Kummert has determined Schubert's cost of equity, cost of debt, and weighted average cost of capital (WACC) to be 12.8%

Kummert has determined Schubert's cost of equity, cost of debt, and weighted average cost of capital (WACC) to be 12.8%, 8.4%, and 11.9%, respectively. Book value of long-term debt and equity was $6,200,000 and $3,281,000 respectively on January 1, 2008. The stock price on December 31, 2008, is $36 per share and there are 130,000 shares outstanding. The relevant tax rate is 30%, and return on equity (ROE) is expected to be 14%.

Summarized financial information about Schubert for 2008 is provided in Exhibits 1 and 2.

Exhibit 1: Schubert, Inc., Balance Sheet on December 31, 2008

Cash	$ 125,000	Accounts payable	$ 426,000
Accounts receivable	975,000	Accrued liabilities	774,000
Inventory	1,215,000	Long-term debt	6,211,000
Fixed assets (net)	9,277,000		
		Common shares	2,100,000
		Retained earnings	2,081,000
Total assets	$11,592,000	Total liabilities and equity	$11,592,000

Exhibit 2: Schubert, Inc., Income Statement for the year ended December 31, 2008

Sales	$9,423,000
Cost of sales	4,580,000
Selling, general, and administrative	1,230,000
Depreciation	1,745,000
Interest expense	522,000
Income tax expense	403,800
Net income	$942,200

Based on his analysis of several years of financial statements, Kummert notes that 2008 was an exceptionally profitable year for Schubert, and that its dividend payouts are usually low because the funds are mainly reinvested in the firm to promote growth. Furthermore, there are very few nonrecurring items on the income statement. Upon review of Kummert's preliminary report, Alter concurs with his analysis of the financial statements but reminds him that Schubert's long-term debt is currently trading at 95% of its book value. He also cautions Kummert that violations of the clean surplus relation can bias the results of the residual income model.

The consensus annual EPS estimate for 2009 is $4.50, and the dividend payout ratio for 2009 is estimated at 5%.

.....

Regarding Alter's caution about violations of the clean surplus relationship, examples of items that can violate this relationship include:

A) foreign currency gains and losses under the current rate method.

B) changes in the market value of debt and equity held as trading securities.

C) changes in net working capital.

Question #37 of 60

Question ID: 691885

Questions 37-42 relate to Ferguson Department Stores, Inc.

Matthew Emery, CFA, is responsible for analyzing companies in the retail industry. He is currently reviewing the status of Ferguson Department Stores, Inc. (FDS). FDS has recently gone through extensive restructuring in the wake of a slowdown in the economy that has made retailing particularly challenging. As part of his analysis, Emery has gathered information from a number of sources.

Ferguson Department Stores, Inc.

FDS went public in 1969 following a major acquisition, and the Ferguson name quickly became one of the most recognized in retailing. Ferguson had been successful through most of its first 30 years in business and has prided itself on being the one-stop shopping destination for consumers living on the West Coast of the United States. Recently, FDS began to experience both top and bottom line difficulties due to increased competition from specialty retailers who could operate more efficiently and offer a wider range of products in a focused retailing sector. When the company's main bank reduced FDS's line of credit, a serious working capital crisis ensued, and the company was forced to issue additional equity in an effort to overcome the problem. FDS has a cost of capital of 10% and a required rate of return on equity of 12%. Dividends are growing at a rate of 8%, but the growth rate is expected to decline linearly over the next six years to a long-term growth rate of 4%. The company recently paid an annual dividend of $1.

At the end of 2008, FDS announced that it would be expanding its retail operations, moving to a warehouse concept, and opening new stores around the country. FDS also announced it would close some existing stores, write-down assets, and take a large restructuring charge. Upon reviewing the prospects of the firm, Emery issued an earnings-per-share forecast for 2009 of $0.90. He set a 12-month share price target of $22.50. Immediately following the expansion announcement, the share price of FDS jumped from $14 to $18.

Exhibit 1: Summary Income Statement, Ferguson Department Stores, Inc.
(U.S. $ millions, except per share data and shares outstanding)

	2008	*2007*
Sales	$6,435.9	$6,322.7
Cost of goods sold, operating, administrative, and selling expenses	6,007.9	5,875.9
Depreciation and amortization	148.7	146.6
Interest expense	59.8	59.5
Unusual items-expense	189.1	5.0
Earnings before tax	30.4	235.7
Income taxes-current	49.3	7.5
Income taxes-future	(71.1)	93.5
	(21.8)	101.0
Net earnings for the year	$52.2	$134.7
Earnings per share: Basic	$0.49	$1.26
Fully diluted	$0.49	$1.26
Weighted average shares outstanding	106,530,610	106,530,610

In 2008, FDS also reported an unusual expense of $189.1 million related to restructuring costs and asset write downs.

Exhibit 2: Selected Industry Information for 2008

Estimated earnings growth rate	0.10
Mean trailing price/earnings (P/E) ratio	22.50
Mean price/sales (P/S) ratio	0.50

In response to questions from a colleague, Emery makes the following statements regarding the merits of earnings yield compared to the P/E ratio:

Statement 1:	For ranking purposes, earnings yield may be useful whenever earnings are either negative or close to zero.
Statement 2:	A high E/P implies the security is overpriced.

.....

The value of one share of FDS using the H-model is *closest* to:

A) $14.50.

B) $16.50.

C) $19.33.

Question #38 of 60

Question ID: 691884

Matthew Emery, CFA, is responsible for analyzing companies in the retail industry. He is currently reviewing the status of Ferguson Department Stores, Inc. (FDS). FDS has recently gone through extensive restructuring in the wake of a slowdown in the economy that has made retailing particularly challenging. As part of his analysis, Emery has gathered information from a number of sources.

Ferguson Department Stores, Inc.

FDS went public in 1969 following a major acquisition, and the Ferguson name quickly became one of the most recognized in retailing. Ferguson had been successful through most of its first 30 years in business and has prided itself on being the one-stop shopping destination for consumers living on the West Coast of the United States. Recently, FDS began to experience both top and bottom line difficulties due to increased competition from specialty retailers who could operate more efficiently and offer a wider range of products in a focused retailing sector. When the company's main bank reduced FDS's line of credit, a serious working capital crisis ensued, and the company was forced to issue additional equity in an effort to overcome the problem. FDS has a cost of capital of 10% and a required rate of return on equity of 12%. Dividends are growing at a rate of 8%, but the growth rate is expected to decline linearly over the next six years to a long-term growth rate of 4%. The company recently paid an annual dividend of $1.

At the end of 2008, FDS announced that it would be expanding its retail operations, moving to a warehouse concept, and opening new stores around the country. FDS also announced it would close some existing stores, write-down assets, and take a large restructuring charge. Upon reviewing the prospects of the firm, Emery issued an earnings-per-share forecast for 2009

a large restructuring charge. Upon reviewing the prospects of the firm, Emery issued an earnings per share forecast for 2009 of $0.90. He set a 12-month share price target of $22.50. Immediately following the expansion announcement, the share price of FDS jumped from $14 to $18.

Exhibit 1: Summary Income Statement, Ferguson Department Stores, Inc.
(U.S. $ millions, except per share data and shares outstanding)

	2008	*2007*
Sales	$6,435.9	$6,322.7
Cost of goods sold, operating, administrative, and selling expenses	6,007.9	5,875.9
Depreciation and amortization	148.7	146.6
Interest expense	59.8	59.5
Unusual items-expense	189.1	5.0
Earnings before tax	30.4	235.7
Income taxes-current	49.3	7.5
Income taxes-future	(71.1)	93.5
	(21.8)	101.0
Net earnings for the year	$52.2	$134.7
Earnings per share: Basic	$0.49	$1.26
Fully diluted	$0.49	$1.26
Weighted average shares outstanding	106,530,610	106,530,610

In 2008, FDS also reported an unusual expense of $189.1 million related to restructuring costs and asset write downs.

Exhibit 2: Selected Industry Information for 2008

Estimated earnings growth rate	0.10
Mean trailing price/earnings (P/E) ratio	22.50
Mean price/sales (P/S) ratio	0.50

In response to questions from a colleague, Emery makes the following statements regarding the merits of earnings yield compared to the P/E ratio:

Statement 1: For ranking purposes, earnings yield may be useful whenever earnings are either negative or close to zero.

Statement 2: A high E/P implies the security is overpriced.

.....

Given Emery's dividend forecast for FDS, is the H-model the appropriate valuation model to use to value FDS?

A) Yes.

B) No, the H-model is appropriate when the dividend growth rate declines at a linear rate for a short period of time during stage one, followed by a 1-year suspension in dividends before the previous dividend is reinstated, and then dividends grow at a

long-term constant rate.

C) No, the H-model is appropriate when the dividend growth rate grows during the first stage followed by a period of stable growth in dividends in stage two, followed by a dividend growth rate that declines linearly in perpetuity.

Question #39 of 60

Question ID: 691883

Matthew Emery, CFA, is responsible for analyzing companies in the retail industry. He is currently reviewing the status of Ferguson Department Stores, Inc. (FDS). FDS has recently gone through extensive restructuring in the wake of a slowdown in the economy that has made retailing particularly challenging. As part of his analysis, Emery has gathered information from a number of sources.

Ferguson Department Stores, Inc.

FDS went public in 1969 following a major acquisition, and the Ferguson name quickly became one of the most recognized in retailing. Ferguson had been successful through most of its first 30 years in business and has prided itself on being the one-stop shopping destination for consumers living on the West Coast of the United States. Recently, FDS began to experience both top and bottom line difficulties due to increased competition from specialty retailers who could operate more efficiently and offer a wider range of products in a focused retailing sector. When the company's main bank reduced FDS's line of credit, a serious working capital crisis ensued, and the company was forced to issue additional equity in an effort to overcome the problem. FDS has a cost of capital of 10% and a required rate of return on equity of 12%. Dividends are growing at a rate of 8%, but the growth rate is expected to decline linearly over the next six years to a long-term growth rate of 4%. The company recently paid an annual dividend of $1.

At the end of 2008, FDS announced that it would be expanding its retail operations, moving to a warehouse concept, and opening new stores around the country. FDS also announced it would close some existing stores, write-down assets, and take a large restructuring charge. Upon reviewing the prospects of the firm, Emery issued an earnings-per-share forecast for 2009 of $0.90. He set a 12-month share price target of $22.50. Immediately following the expansion announcement, the share price of FDS jumped from $14 to $18.

Exhibit 1: Summary Income Statement, Ferguson Department Stores, Inc.
(U.S. $ millions, except per share data and shares outstanding)

	2008	*2007*
Sales	$6,435.9	$6,322.7
Cost of goods sold, operating, administrative, and selling expenses	6,007.9	5,875.9
Depreciation and amortization	148.7	146.6
Interest expense	59.8	59.5
Unusual items-expense	189.1	5.0
Earnings before tax	30.4	235.7
Income taxes-current	49.3	7.5
Income taxes-future	(71.1)	93.5

Income taxes-future	(21.8)	101.0
Net earnings for the year	$52.2	$134.7
Earnings per share: Basic	$0.49	$1.26
Fully diluted	$0.49	$1.26
Weighted average shares outstanding	106,530,610	106,530,610

In 2008, FDS also reported an unusual expense of $189.1 million related to restructuring costs and asset write downs.

Exhibit 2: Selected Industry Information for 2008

Estimated earnings growth rate	0.10
Mean trailing price/earnings (P/E) ratio	22.50
Mean price/sales (P/S) ratio	0.50

In response to questions from a colleague, Emery makes the following statements regarding the merits of earnings yield compared to the P/E ratio:

Statement 1: For ranking purposes, earnings yield may be useful whenever earnings are either negative or close to zero.

Statement 2: A high E/P implies the security is overpriced.

.....

Assuming that the cost of equity for FDS does not change, the present value of growth opportunities in the share price following the announcement that the company would be expanding its retail operations, using Emery's 2009 earnings forecast, is *closest* to:

A) $9.00.

B) $10.50.

C) $12.50.

Question #40 of 60

Question ID: 691887

Matthew Emery, CFA, is responsible for analyzing companies in the retail industry. He is currently reviewing the status of Ferguson Department Stores, Inc. (FDS). FDS has recently gone through extensive restructuring in the wake of a slowdown in the economy that has made retailing particularly challenging. As part of his analysis, Emery has gathered information from a number of sources.

Ferguson Department Stores, Inc.

FDS went public in 1969 following a major acquisition, and the Ferguson name quickly became one of the most recognized in retailing. Ferguson had been successful through most of its first 30 years in business and has prided itself on being the one-stop shopping destination for consumers living on the West Coast of the United States. Recently, FDS began to experience both top and bottom line difficulties due to increased competition from specialty retailers who could operate more efficiently

and offer a wider range of products in a focused retailing sector. When the company's main bank reduced FDS's line of credit, a serious working capital crisis ensued, and the company was forced to issue additional equity in an effort to overcome the problem. FDS has a cost of capital of 10% and a required rate of return on equity of 12%. Dividends are growing at a rate of 8%, but the growth rate is expected to decline linearly over the next six years to a long-term growth rate of 4%. The company recently paid an annual dividend of $1.

At the end of 2008, FDS announced that it would be expanding its retail operations, moving to a warehouse concept, and opening new stores around the country. FDS also announced it would close some existing stores, write-down assets, and take a large restructuring charge. Upon reviewing the prospects of the firm, Emery issued an earnings-per-share forecast for 2009 of $0.90. He set a 12-month share price target of $22.50. Immediately following the expansion announcement, the share price of FDS jumped from $14 to $18.

Exhibit 1: Summary Income Statement, Ferguson Department Stores, Inc.
(U.S. $ millions, except per share data and shares outstanding)

	2008	*2007*
Sales	$6,435.9	$6,322.7
Cost of goods sold, operating, administrative, and selling expenses	6,007.9	5,875.9
Depreciation and amortization	148.7	146.6
Interest expense	59.8	59.5
Unusual items-expense	189.1	5.0
Earnings before tax	30.4	235.7
Income taxes-current	49.3	7.5
Income taxes-future	(71.1)	93.5
	(21.8)	101.0
Net earnings for the year	$52.2	$134.7
Earnings per share: Basic	$0.49	$1.26
Fully diluted	$0.49	$1.26
Weighted average shares outstanding	106,530,610	106,530,610

In 2008, FDS also reported an unusual expense of $189.1 million related to restructuring costs and asset write downs.

Exhibit 2: Selected Industry Information for 2008

Estimated earnings growth rate	0.10
Mean trailing price/earnings (P/E) ratio	22.50
Mean price/sales (P/S) ratio	0.50

In response to questions from a colleague, Emery makes the following statements regarding the merits of earnings yield compared to the P/E ratio:

Statement 1: For ranking purposes, earnings yield may be useful whenever earnings are either negative or close to zero.

Statement 2: A high E/P implies the security is overpriced.

Are Emery's statements regarding the earnings yield and E/P ratio correct?

A) One statement is correct and the other statement is incorrect.

B) Both statements are correct.

C) Both statements are incorrect.

Question #41 of 60

Question ID: 691886

Matthew Emery, CFA, is responsible for analyzing companies in the retail industry. He is currently reviewing the status of Ferguson Department Stores, Inc. (FDS). FDS has recently gone through extensive restructuring in the wake of a slowdown in the economy that has made retailing particularly challenging. As part of his analysis, Emery has gathered information from a number of sources.

Ferguson Department Stores, Inc.

FDS went public in 1969 following a major acquisition, and the Ferguson name quickly became one of the most recognized in retailing. Ferguson had been successful through most of its first 30 years in business and has prided itself on being the one-stop shopping destination for consumers living on the West Coast of the United States. Recently, FDS began to experience both top and bottom line difficulties due to increased competition from specialty retailers who could operate more efficiently and offer a wider range of products in a focused retailing sector. When the company's main bank reduced FDS's line of credit, a serious working capital crisis ensued, and the company was forced to issue additional equity in an effort to overcome the problem. FDS has a cost of capital of 10% and a required rate of return on equity of 12%. Dividends are growing at a rate of 8%, but the growth rate is expected to decline linearly over the next six years to a long-term growth rate of 4%. The company recently paid an annual dividend of $1.

At the end of 2008, FDS announced that it would be expanding its retail operations, moving to a warehouse concept, and opening new stores around the country. FDS also announced it would close some existing stores, write-down assets, and take a large restructuring charge. Upon reviewing the prospects of the firm, Emery issued an earnings-per-share forecast for 2009 of $0.90. He set a 12-month share price target of $22.50. Immediately following the expansion announcement, the share price of FDS jumped from $14 to $18.

Exhibit 1: Summary Income Statement, Ferguson Department Stores, Inc.
(U.S. $ millions, except per share data and shares outstanding)

	2008	*2007*
Sales	$6,435.9	$6,322.7
Cost of goods sold, operating, administrative, and selling expenses	6,007.9	5,875.9
Depreciation and amortization	148.7	146.6
Interest expense	59.8	59.5
Unusual items-expense	189.1	5.0

Earnings before tax	30.4	235.7
Income taxes-current	49.3	7.5
Income taxes-future	(71.1)	93.5
	(21.8)	101.0
Net earnings for the year	$52.2	$134.7
Earnings per share: Basic	$0.49	$1.26
Fully diluted	$0.49	$1.26
Weighted average shares outstanding	106,530,610	106,530,610

In 2008, FDS also reported an unusual expense of $189.1 million related to restructuring costs and asset write downs.

Exhibit 2: Selected Industry Information for 2008

Estimated earnings growth rate	0.10
Mean trailing price/earnings (P/E) ratio	22.50
Mean price/sales (P/S) ratio	0.50

In response to questions from a colleague, Emery makes the following statements regarding the merits of earnings yield compared to the P/E ratio:

Statement 1:	For ranking purposes, earnings yield may be useful whenever earnings are either negative or close to zero.
Statement 2:	A high E/P implies the security is overpriced.

.....

Assuming a tax rate of 34%, the underlying earnings per share (EPS) for FDS in 2008 is *closest* to:

A) $1.26.

B) $1.36.

C) $2.27.

Question #42 of 60

Question ID: 691888

Matthew Emery, CFA, is responsible for analyzing companies in the retail industry. He is currently reviewing the status of Ferguson Department Stores, Inc. (FDS). FDS has recently gone through extensive restructuring in the wake of a slowdown in the economy that has made retailing particularly challenging. As part of his analysis, Emery has gathered information from a number of sources.

Ferguson Department Stores, Inc.

FDS went public in 1969 following a major acquisition, and the Ferguson name quickly became one of the most recognized in retailing. Ferguson had been successful through most of its first 30 years in business and has prided itself on being the one-

stop shopping destination for consumers living on the West Coast of the United States. Recently, FDS began to experience both top and bottom line difficulties due to increased competition from specialty retailers who could operate more efficiently and offer a wider range of products in a focused retailing sector. When the company's main bank reduced FDS's line of credit, a serious working capital crisis ensued, and the company was forced to issue additional equity in an effort to overcome the problem. FDS has a cost of capital of 10% and a required rate of return on equity of 12%. Dividends are growing at a rate of 8%, but the growth rate is expected to decline linearly over the next six years to a long-term growth rate of 4%. The company recently paid an annual dividend of $1.

At the end of 2008, FDS announced that it would be expanding its retail operations, moving to a warehouse concept, and opening new stores around the country. FDS also announced it would close some existing stores, write-down assets, and take a large restructuring charge. Upon reviewing the prospects of the firm, Emery issued an earnings-per-share forecast for 2009 of $0.90. He set a 12-month share price target of $22.50. Immediately following the expansion announcement, the share price of FDS jumped from $14 to $18.

Exhibit 1: Summary Income Statement, Ferguson Department Stores, Inc.
(U.S. $ millions, except per share data and shares outstanding)

	2008	*2007*
Sales	$6,435.9	$6,322.7
Cost of goods sold, operating, administrative, and selling expenses	6,007.9	5,875.9
Depreciation and amortization	148.7	146.6
Interest expense	59.8	59.5
Unusual items-expense	189.1	5.0
Earnings before tax	30.4	235.7
Income taxes-current	49.3	7.5
Income taxes-future	(71.1)	93.5
	(21.8)	101.0
Net earnings for the year	$52.2	$134.7
Earnings per share: Basic	$0.49	$1.26
Fully diluted	$0.49	$1.26
Weighted average shares outstanding	106,530,610	106,530,610

In 2008, FDS also reported an unusual expense of $189.1 million related to restructuring costs and asset write downs.

Exhibit 2: Selected Industry Information for 2008

Estimated earnings growth rate	0.10
Mean trailing price/earnings (P/E) ratio	22.50
Mean price/sales (P/S) ratio	0.50

In response to questions from a colleague, Emery makes the following statements regarding the merits of earnings yield compared to the P/E ratio:

Statement 1: For ranking purposes, earnings yield may be useful whenever earnings are either negative or close to zero

earnings are either negative or close to zero.

Statement 2: A high E/P implies the security is overpriced.

.....

According to FDS's price-to-sales ratio for 2008, based on the post-expansion announcement stock price, FDS is:

A) underpriced relative to the industry.

B) overpriced relative to the industry.

C) properly priced relative to the industry.

Question #43 of 60

Question ID: 693979

Questions 43-48 relate to Universal Home Supplies, Inc.

Michael Robbins, CFA, is analyzing Universal Home Supplies, Inc. (UHS), which has recently gone through some extensive restructuring.

Universal Home Supplies, Inc.

UHS operates nearly 200 department stores and 78 specialty stores in over 30 states. The company offers a wide range of products, including women's, men's, and children's clothing and accessories, as well as home furnishings, electronics, and other consumer goods. The company is considering cutting back on or eliminating its electronics business entirely. UHS manufactures many of its own apparel products domestically in a large factory located in Kentucky. This central location permits shipping to distribution points around the country at reasonable costs. The company operates primarily in suburban shopping malls and offers mid- to high-end merchandise mainly under its own private label. At present, more than 70% of the company's customers live within a 10-minute drive of one of the company's stores. Web site activity measured in dollar sales volume has increased by over 18% in the past year. Shares of UHS stock are currently priced at $25. Dividends are expected to grow at a rate of 6% over the next eight years and then continue to grow at that same rate indefinitely. The company has a cost of capital of 10.2%, a beta of 0.8, and just paid an annual dividend of $1.25.

UHS has faced serious cash flow problems in recent years as a consequence of its strategy to pursue an upscale clientele in the face of increased competition from several "niche retailers." The firm has been able to issue new debt recently and has also managed to extend its line of credit. The two financing agreements required a pledge of additional assets and a promise to install a super-efficient inventory tracking system in time to meet holiday shopping demand.

Exhibit 1: Summary Income Statement for Universal Home Supplies, Inc. (U.S. $ millions, except per share data and shares outstanding)

	2008	*2007*
Sales	$7,400.1	$7,383.8
Cost of goods sold, operating, administrative, and selling expenses	7,081.3	7,028.9
Depreciation and amortization	157.7	155.6
Earnings before interest expense and income taxes	161.1	199.3

Interest expense	42.6	45.4
Earnings before tax	118.5	153.9
Income taxes-current	40.3	52.3
Net earnings for the year	$78.2	$101.6
Earnings per share: Basic	$0.82	$1.40
Fully diluted	$0.82	$1.34
Weighted average shares outstanding	95,366,000	72,572,000

Exhibit 2: Book Value per Share (BVPS in $) and Return on Equity (ROE), Universal Home Supplies, Inc.

Year	*2008*	*2007*	*2006*	*2005*
BVPS	$25.58	$33.62	$37.54	$32.26
ROE	3.2%	4.0%	4.5%	3.9%

Exhibit 3: 2008 Selected Industry Information

Estimated earnings growth rate	0.10
Mean trailing price/earnings (P/E) ratio	22.50
Mean price/sales (P/S) ratio	0.50

Robbins is asked by his supervisor to carefully consider the advantages and drawbacks of using the price-to-sales ratio (P/S) and to determine the appropriate valuation metrics to use when returns follow patterns of persistence or reversals.

Robbins also estimates a cross-sectional model to predict UHS's P/E:

> predicted P/E = 5 − (10 × beta) + (3 × 4-year average ROE(%)]
> + [2 × 8-year growth forecast(%)]

where ROE and growth forecast are in percentages (i.e., 10 instead of 0.10 for 10%).

.....

Based on the H-model, the implied expected rate of return for UHS is *closest* to:

A) 8.8%.

B) 10.2%.

C) 11.3%.

Question #44 of 60

Question ID: 693980

Michael Robbins, CFA, is analyzing Universal Home Supplies, Inc. (UHS), which has recently gone through some extensive restructuring.

Universal Home Supplies, Inc.

UHS operates nearly 200 department stores and 78 specialty stores in over 30 states. The company offers a wide range of products, including women's, men's, and children's clothing and accessories, as well as home furnishings, electronics, and other consumer goods. The company is considering cutting back on or eliminating its electronics business entirely. UHS manufactures many of its own apparel products domestically in a large factory located in Kentucky. This central location permits shipping to distribution points around the country at reasonable costs. The company operates primarily in suburban shopping malls and offers mid- to high-end merchandise mainly under its own private label. At present, more than 70% of the company's customers live within a 10-minute drive of one of the company's stores. Web site activity measured in dollar sales volume has increased by over 18% in the past year. Shares of UHS stock are currently priced at $25. Dividends are expected to grow at a rate of 6% over the next eight years and then continue to grow at that same rate indefinitely. The company has a cost of capital of 10.2%, a beta of 0.8, and just paid an annual dividend of $1.25.

UHS has faced serious cash flow problems in recent years as a consequence of its strategy to pursue an upscale clientele in the face of increased competition from several "niche retailers." The firm has been able to issue new debt recently and has also managed to extend its line of credit. The two financing agreements required a pledge of additional assets and a promise to install a super-efficient inventory tracking system in time to meet holiday shopping demand.

Exhibit 1: Summary Income Statement for Universal Home Supplies, Inc. (U.S. $ millions, except per share data and shares outstanding)

	2008	*2007*
Sales	$7,400.1	$7,383.8
Cost of goods sold, operating, administrative, and selling expenses	7,081.3	7,028.9
Depreciation and amortization	157.7	155.6
Earnings before interest expense and income taxes	161.1	199.3
Interest expense	42.6	45.4
Earnings before tax	118.5	153.9
Income taxes-current	40.3	52.3
Net earnings for the year	$78.2	$101.6
Earnings per share: Basic	$0.82	$1.40
Fully diluted	$0.82	$1.34
Weighted average shares outstanding	95,366,000	72,572,000

Exhibit 2: Book Value per Share (BVPS in $) and Return on Equity (ROE), Universal Home Supplies, Inc.

Year	*2008*	*2007*	*2006*	*2005*
BVPS	$25.58	$33.62	$37.54	$32.26
ROE	3.2%	4.0%	4.5%	3.9%

Exhibit 3: 2008 Selected Industry Information

Estimated earnings growth rate	0.10

Mean trailing price/earnings (P/E) ratio	22.50
Mean price/sales (P/S) ratio	0.50

Robbins is asked by his supervisor to carefully consider the advantages and drawbacks of using the price-to-sales ratio (P/S) and to determine the appropriate valuation metrics to use when returns follow patterns of persistence or reversals.

Robbins also estimates a cross-sectional model to predict UHS's P/E:

> predicted P/E = 5 − (10 × beta) + (3 × 4-year average ROE(%)) + [2 × 8-year growth forecast(%)]

where ROE and growth forecast are in percentages (i.e., 10 instead of 0.10 for 10%).

.....

Robbins should conclude that a key drawback to using the price-to-sales (P/S) ratio in the investment process is that P/S is:

A) positive even when earnings per share is negative.

B) not appropriate for valuing the equity of mature companies.

C) susceptible to manipulation with respect to revenue recognition.

Question #45 of 60

Question ID: 693982

Michael Robbins, CFA, is analyzing Universal Home Supplies, Inc. (UHS), which has recently gone through some extensive restructuring.

Universal Home Supplies, Inc.

UHS operates nearly 200 department stores and 78 specialty stores in over 30 states. The company offers a wide range of products, including women's, men's, and children's clothing and accessories, as well as home furnishings, electronics, and other consumer goods. The company is considering cutting back on or eliminating its electronics business entirely. UHS manufactures many of its own apparel products domestically in a large factory located in Kentucky. This central location permits shipping to distribution points around the country at reasonable costs. The company operates primarily in suburban shopping malls and offers mid- to high-end merchandise mainly under its own private label. At present, more than 70% of the company's customers live within a 10-minute drive of one of the company's stores. Web site activity measured in dollar sales volume has increased by over 18% in the past year. Shares of UHS stock are currently priced at $25. Dividends are expected to grow at a rate of 6% over the next eight years and then continue to grow at that same rate indefinitely. The company has a cost of capital of 10.2%, a beta of 0.8, and just paid an annual dividend of $1.25.

UHS has faced serious cash flow problems in recent years as a consequence of its strategy to pursue an upscale clientele in the face of increased competition from several "niche retailers." The firm has been able to issue new debt recently and has also managed to extend its line of credit. The two financing agreements required a pledge of additional assets and a promise to install a super-efficient inventory tracking system in time to meet holiday shopping demand.

Exhibit 1: Summary Income Statement for Universal Home Supplies, Inc. (U.S. $

millions, except per share data and shares outstanding)

	2008	*2007*
Sales	$7,400.1	$7,383.8
Cost of goods sold, operating, administrative, and selling expenses	7,081.3	7,028.9
Depreciation and amortization	157.7	155.6
Earnings before interest expense and income taxes	161.1	199.3
Interest expense	42.6	45.4
Earnings before tax	118.5	153.9
Income taxes-current	40.3	52.3
Net earnings for the year	$78.2	$101.6
Earnings per share: Basic	$0.82	$1.40
Fully diluted	$0.82	$1.34
Weighted average shares outstanding	95,366,000	72,572,000

Exhibit 2: Book Value per Share (BVPS in $) and Return on Equity (ROE), Universal Home Supplies, Inc.

Year	*2008*	*2007*	*2006*	*2005*
BVPS	$25.58	$33.62	$37.54	$32.26
ROE	3.2%	4.0%	4.5%	3.9%

Exhibit 3: 2008 Selected Industry Information

Estimated earnings growth rate	0.10
Mean trailing price/earnings (P/E) ratio	22.50
Mean price/sales (P/S) ratio	0.50

Robbins is asked by his supervisor to carefully consider the advantages and drawbacks of using the price-to-sales ratio (P/S) and to determine the appropriate valuation metrics to use when returns follow patterns of persistence or reversals.

Robbins also estimates a cross-sectional model to predict UHS's P/E:

> predicted P/E = 5 − (10 × beta) + (3 × 4-year average ROE(%)) + [2 × 8-year growth forecast(%)]

where ROE and growth forecast are in percentages (i.e., 10 instead of 0.10 for 10%).

.....

Is UHS stock, at the end of 2008, *best* described as overvalued or undervalued according to the:

	Trailing PEG ratio?	P/S ratio?
A)	Undervalued	Undervalued

B) Overvalued Undervalued

C) Undervalued Overvalued

Question #46 of 60

Question ID: 693981

Michael Robbins, CFA, is analyzing Universal Home Supplies, Inc. (UHS), which has recently gone through some extensive restructuring.

Universal Home Supplies, Inc.

UHS operates nearly 200 department stores and 78 specialty stores in over 30 states. The company offers a wide range of products, including women's, men's, and children's clothing and accessories, as well as home furnishings, electronics, and other consumer goods. The company is considering cutting back on or eliminating its electronics business entirely. UHS manufactures many of its own apparel products domestically in a large factory located in Kentucky. This central location permits shipping to distribution points around the country at reasonable costs. The company operates primarily in suburban shopping malls and offers mid- to high-end merchandise mainly under its own private label. At present, more than 70% of the company's customers live within a 10-minute drive of one of the company's stores. Web site activity measured in dollar sales volume has increased by over 18% in the past year. Shares of UHS stock are currently priced at $25. Dividends are expected to grow at a rate of 6% over the next eight years and then continue to grow at that same rate indefinitely. The company has a cost of capital of 10.2%, a beta of 0.8, and just paid an annual dividend of $1.25.

UHS has faced serious cash flow problems in recent years as a consequence of its strategy to pursue an upscale clientele in the face of increased competition from several "niche retailers." The firm has been able to issue new debt recently and has also managed to extend its line of credit. The two financing agreements required a pledge of additional assets and a promise to install a super-efficient inventory tracking system in time to meet holiday shopping demand.

Exhibit 1: Summary Income Statement for Universal Home Supplies, Inc. (U.S. $ millions, except per share data and shares outstanding)

	2008	*2007*
Sales	$7,400.1	$7,383.8
Cost of goods sold, operating, administrative, and selling expenses	7,081.3	7,028.9
Depreciation and amortization	157.7	155.6
Earnings before interest expense and income taxes	161.1	199.3
Interest expense	42.6	45.4
Earnings before tax	118.5	153.9
Income taxes-current	40.3	52.3
Net earnings for the year	$78.2	$101.6
Earnings per share: Basic	$0.82	$1.40
Fully diluted	$0.82	$1.34

Weighted average shares outstanding	95,366,000	72,572,000

Exhibit 2: Book Value per Share (BVPS in $) and Return on Equity (ROE), Universal Home Supplies, Inc.

Year	*2008*	*2007*	*2006*	*2005*
BVPS	$25.58	$33.62	$37.54	$32.26
ROE	3.2%	4.0%	4.5%	3.9%

Exhibit 3: 2008 Selected Industry Information

Estimated earnings growth rate	0.10
Mean trailing price/earnings (P/E) ratio	22.50
Mean price/sales (P/S) ratio	0.50

Robbins is asked by his supervisor to carefully consider the advantages and drawbacks of using the price-to-sales ratio (P/S) and to determine the appropriate valuation metrics to use when returns follow patterns of persistence or reversals.

Robbins also estimates a cross-sectional model to predict UHS's P/E:

> predicted P/E = 5 − (10 × beta) + (3 × 4-year average ROE(%)) + [2 × 8-year growth forecast(%)]

where ROE and growth forecast are in percentages (i.e., 10 instead of 0.10 for 10%).

.....

Based on the method of average return on equity (ROE), the normalized EPS for UHS is *closest* to:

A) $0.94.

B) $1.00.

C) $1.26.

Question #47 of 60

Question ID: 693983

Michael Robbins, CFA, is analyzing Universal Home Supplies, Inc. (UHS), which has recently gone through some extensive restructuring.

Universal Home Supplies, Inc.

UHS operates nearly 200 department stores and 78 specialty stores in over 30 states. The company offers a wide range of products, including women's, men's, and children's clothing and accessories, as well as home furnishings, electronics, and other consumer goods. The company is considering cutting back on or eliminating its electronics business entirely. UHS manufactures many of its own apparel products domestically in a large factory located in Kentucky. This central location permits shipping to distribution points around the country at reasonable costs. The company operates primarily in suburban shopping malls and offers mid- to high-end merchandise mainly under its own private label. At present, more than 70% of the

shopping malls and offers mid- to high-end merchandise mainly under its own private label. At present, more than 70% of the company's customers live within a 10-minute drive of one of the company's stores. Web site activity measured in dollar sales volume has increased by over 18% in the past year. Shares of UHS stock are currently priced at $25. Dividends are expected to grow at a rate of 6% over the next eight years and then continue to grow at that same rate indefinitely. The company has a cost of capital of 10.2%, a beta of 0.8, and just paid an annual dividend of $1.25.

UHS has faced serious cash flow problems in recent years as a consequence of its strategy to pursue an upscale clientele in the face of increased competition from several "niche retailers." The firm has been able to issue new debt recently and has also managed to extend its line of credit. The two financing agreements required a pledge of additional assets and a promise to install a super-efficient inventory tracking system in time to meet holiday shopping demand.

Exhibit 1: Summary Income Statement for Universal Home Supplies, Inc. (U.S. $ millions, except per share data and shares outstanding)

	2008	*2007*
Sales	$7,400.1	$7,383.8
Cost of goods sold, operating, administrative, and selling expenses	7,081.3	7,028.9
Depreciation and amortization	157.7	155.6
Earnings before interest expense and income taxes	161.1	199.3
Interest expense	42.6	45.4
Earnings before tax	118.5	153.9
Income taxes-current	40.3	52.3
Net earnings for the year	$78.2	$101.6
Earnings per share: Basic	$0.82	$1.40
Fully diluted	$0.82	$1.34
Weighted average shares outstanding	95,366,000	72,572,000

Exhibit 2: Book Value per Share (BVPS in $) and Return on Equity (ROE), Universal Home Supplies, Inc.

Year	*2008*	*2007*	*2006*	*2005*
BVPS	$25.58	$33.62	$37.54	$32.26
ROE	3.2%	4.0%	4.5%	3.9%

Exhibit 3: 2008 Selected Industry Information

Estimated earnings growth rate	0.10
Mean trailing price/earnings (P/E) ratio	22.50
Mean price/sales (P/S) ratio	0.50

Robbins is asked by his supervisor to carefully consider the advantages and drawbacks of using the price-to-sales ratio (P/S) and to determine the appropriate valuation metrics to use when returns follow patterns of persistence or reversals.

Robbins also estimates a cross-sectional model to predict UHS's P/E:

predicted P/E = 5 − (10 × beta) + (3 × 4-year average ROE(%)]
+ [2 × 8-year growth forecast(%)]

where ROE and growth forecast are in percentages (i.e., 10 instead of 0.10 for 10%).

.....

The predicted P/E for UHS using Robbins's model is *closest* to:

A) 20.7.

B) 23.6.

C) 30.5.

Question #48 of 60

Question ID: 693984

Michael Robbins, CFA, is analyzing Universal Home Supplies, Inc. (UHS), which has recently gone through some extensive restructuring.

Universal Home Supplies, Inc.

UHS operates nearly 200 department stores and 78 specialty stores in over 30 states. The company offers a wide range of products, including women's, men's, and children's clothing and accessories, as well as home furnishings, electronics, and other consumer goods. The company is considering cutting back on or eliminating its electronics business entirely. UHS manufactures many of its own apparel products domestically in a large factory located in Kentucky. This central location permits shipping to distribution points around the country at reasonable costs. The company operates primarily in suburban shopping malls and offers mid- to high-end merchandise mainly under its own private label. At present, more than 70% of the company's customers live within a 10-minute drive of one of the company's stores. Web site activity measured in dollar sales volume has increased by over 18% in the past year. Shares of UHS stock are currently priced at $25. Dividends are expected to grow at a rate of 6% over the next eight years and then continue to grow at that same rate indefinitely. The company has a cost of capital of 10.2%, a beta of 0.8, and just paid an annual dividend of $1.25.

UHS has faced serious cash flow problems in recent years as a consequence of its strategy to pursue an upscale clientele in the face of increased competition from several "niche retailers." The firm has been able to issue new debt recently and has also managed to extend its line of credit. The two financing agreements required a pledge of additional assets and a promise to install a super-efficient inventory tracking system in time to meet holiday shopping demand.

Exhibit 1: Summary Income Statement for Universal Home Supplies, Inc. (U.S. $ millions, except per share data and shares outstanding)

	2008	*2007*
Sales	$7,400.1	$7,383.8
Cost of goods sold, operating, administrative, and selling expenses	7,081.3	7,028.9
Depreciation and amortization	157.7	155.6

Earnings before interest expense and income taxes	161.1	199.3
Interest expense	42.6	45.4
Earnings before tax	118.5	153.9
Income taxes-current	40.3	52.3
Net earnings for the year	$78.2	$101.6
Earnings per share: Basic	$0.82	$1.40
Fully diluted	$0.82	$1.34
Weighted average shares outstanding	95,366,000	72,572,000

Exhibit 2: Book Value per Share (BVPS in $) and Return on Equity (ROE), Universal Home Supplies, Inc.

Year	*2008*	*2007*	*2006*	*2005*
BVPS	$25.58	$33.62	$37.54	$32.26
ROE	3.2%	4.0%	4.5%	3.9%

Exhibit 3: 2008 Selected Industry Information

Estimated earnings growth rate	0.10
Mean trailing price/earnings (P/E) ratio	22.50
Mean price/sales (P/S) ratio	0.50

Robbins is asked by his supervisor to carefully consider the advantages and drawbacks of using the price-to-sales ratio (P/S) and to determine the appropriate valuation metrics to use when returns follow patterns of persistence or reversals.

Robbins also estimates a cross-sectional model to predict UHS's P/E:

> predicted P/E = 5 − (10 × beta) + (3 × 4-year average ROE(%)]
> + [2 × 8-year growth forecast(%)]

where ROE and growth forecast are in percentages (i.e., 10 instead of 0.10 for 10%).

.....

Robbins should conclude that patterns of persistence or reversals in returns provide the *most appropriate* rationale for valuation using:

A) unexpected earnings.

B) relative-strength indicators.

C) standardized unexpected earnings.

Question #49 of 60

Question ID: 691253

Questions 49-54 relate to William Rogers

Questions 49-54 relate to William Rogers.

William Rogers, a fixed-income portfolio manager, needs to eliminate a large cash position in his portfolio. He would like to purchase some corporate bonds. Two bonds that he is evaluating are shown in Exhibit 1. These two bonds are from the same issuer, and the current call price for the callable bond is 100. Assume that the issuer will call if the bond price exceeds the call price.

Rogers is also concerned about increases in interest rates and is considering the purchase of a putable bond. He wants to determine how assumed increases or decreases in interest rate volatility affect the value of the straight bonds and bonds with embedded options. After Rogers performs some analysis, he and his supervisor, Sigourney Walters, discuss the relative price movement between the two bonds in Exhibit 1 when interest rates change significantly.

During the discussions, Rogers makes the following statements:

Statement 1:	If the volatility of interest rates decreases, the value of the callable bond will increase.
Statement 2:	The noncallable bond will not be affected by a change in the volatility or level of interest rates.
Statement 3:	When interest rates decrease, the value of the noncallable bond increases by more than the callable bond.
Statement 4:	If the volatility of interest rates increases, the value of the putable bond will increase.

Walters mentors Rogers on bond concepts and then asks him to consider the pricing of a third bond. The third bond has five years to maturity, a 6% annual coupon, and pays interest semiannually. The bond is both callable and putable at 100 at any time. Walters indicates that the holders of the bond's embedded options will exercise if the option is in-the-money.

Exhibit 1: Bond Descriptions

	Noncallable Bond	*Callable Bond*
Price	99.77	98.21
Time to maturity (years)	5	5
Time to first call date (years)	n/a	4
Annual coupon	6.00%	6.00%
Interest payment	Semiannual	Semiannual
Yield to maturity	6.0542%	6.4227%

Rogers obtained the prices shown in Exhibit 1 using software that generates an interest rate lattice. He uses his software to generate the interest rate lattice shown in Exhibit 2.

Exhibit 2: Interest Rate Lattice (Annualized Interest Rates)

		15.44%
	14.10%	
12.69%		12.46%
11.85%	11.38%	

					9.75%		10.25%		10.05%
				8.95%		9.57%		9.19%	
			7.91%		7.88%		8.28%		8.11%
		7.35%		7.23%		7.74%		7.42%	
	6.62%		6.40%		6.37%		6.69%		6.54%
6.05%		5.95%		5.85%		6.25%		5.99%	
	5.36%		5.17%		5.15%		5.40%		5.28%
		4.81%		4.73%		5.05%		4.83%	
			4.18%		4.16%		4.36%		4.26%
				3.82%		4.08%		3.90%	
					3.37%		3.52%		3.44%
						3.30%		3.15%	
							2.84%		2.77%
								2.54%	
									2.24%
Years	0.5	1.0	1.5	2.0	2.5	3.0	3.5	4.0	4.5

.....

Evaluate Rogers's statements 1 and 3.

A) Only Statement 1 is correct.

B) Only Statement 3 is correct.

C) Both statements are correct.

Question #50 of 60

Question ID: 691254

William Rogers, a fixed-income portfolio manager, needs to eliminate a large cash position in his portfolio. He would like to purchase some corporate bonds. Two bonds that he is evaluating are shown in Exhibit 1. These two bonds are from the same issuer, and the current call price for the callable bond is 100. Assume that the issuer will call if the bond price exceeds the call price.

Rogers is also concerned about increases in interest rates and is considering the purchase of a putable bond. He wants to determine how assumed increases or decreases in interest rate volatility affect the value of the straight bonds and bonds with embedded options. After Rogers performs some analysis, he and his supervisor, Sigourney Walters, discuss the relative price movement between the two bonds in Exhibit 1 when interest rates change significantly.

During the discussions, Rogers makes the following statements:

Statement 1: If the volatility of interest rates decreases, the value of the callable bond will increase.

callable bond will increase.

Statement 2:	The noncallable bond will not be affected by a change in the volatility or level of interest rates.
Statement 3:	When interest rates decrease, the value of the noncallable bond increases by more than the callable bond.
Statement 4:	If the volatility of interest rates increases, the value of the putable bond will increase.

Walters mentors Rogers on bond concepts and then asks him to consider the pricing of a third bond. The third bond has five years to maturity, a 6% annual coupon, and pays interest semiannually. The bond is both callable and putable at 100 at any time. Walters indicates that the holders of the bond's embedded options will exercise if the option is in-the-money.

Exhibit 1: Bond Descriptions

	Noncallable Bond	*Callable Bond*
Price	99.77	98.21
Time to maturity (years)	5	5
Time to first call date (years)	n/a	4
Annual coupon	6.00%	6.00%
Interest payment	Semiannual	Semiannual
Yield to maturity	6.0542%	6.4227%

Rogers obtained the prices shown in Exhibit 1 using software that generates an interest rate lattice. He uses his software to generate the interest rate lattice shown in Exhibit 2.

Exhibit 2: Interest Rate Lattice (Annualized Interest Rates)

								15.44%
							14.10%	
						12.69%		12.46%
					11.85%		11.38%	
				9.75%		10.25%		10.05%
			8.95%		9.57%		9.19%	
		7.91%		7.88%		8.28%		8.11%
	7.35%		7.23%		7.74%		7.42%	
6.62%		6.40%		6.37%		6.69%		6.54%
6.05%	5.95%		5.85%		6.25%		5.99%	
5.36%		5.17%		5.15%		5.40%		5.28%
	4.81%		4.73%		5.05%		4.83%	
		4.18%		4.16%		4.36%		4.26%
			3.82%		4.08%		3.90%	
				3.37%		3.52%		3.44%

						3.30%		3.15%	
							2.84%		2.77%
								2.54%	
									2.24%
Years	0.5	1.0	1.5	2.0	2.5	3.0	3.5	4.0	4.5

.....

Evaluate Rogers's statements 2 and 4.

A) Only Statement 2 is correct.

B) Only Statement 4 is correct.

C) Both statements are correct.

Question #51 of 60

Question ID: 691252

William Rogers, a fixed-income portfolio manager, needs to eliminate a large cash position in his portfolio. He would like to purchase some corporate bonds. Two bonds that he is evaluating are shown in Exhibit 1. These two bonds are from the same issuer, and the current call price for the callable bond is 100. Assume that the issuer will call if the bond price exceeds the call price.

Rogers is also concerned about increases in interest rates and is considering the purchase of a putable bond. He wants to determine how assumed increases or decreases in interest rate volatility affect the value of the straight bonds and bonds with embedded options. After Rogers performs some analysis, he and his supervisor, Sigourney Walters, discuss the relative price movement between the two bonds in Exhibit 1 when interest rates change significantly.

During the discussions, Rogers makes the following statements:

Statement 1:	If the volatility of interest rates decreases, the value of the callable bond will increase.
Statement 2:	The noncallable bond will not be affected by a change in the volatility or level of interest rates.
Statement 3:	When interest rates decrease, the value of the noncallable bond increases by more than the callable bond.
Statement 4:	If the volatility of interest rates increases, the value of the putable bond will increase.

Walters mentors Rogers on bond concepts and then asks him to consider the pricing of a third bond. The third bond has five years to maturity, a 6% annual coupon, and pays interest semiannually. The bond is both callable and putable at 100 at any time. Walters indicates that the holders of the bond's embedded options will exercise if the option is in-the-money.

Exhibit 1: Bond Descriptions

	Noncallable Bond	*Callable Bond*

	Bond	
Price	99.77	98.21
Time to maturity (years)	5	5
Time to first call date (years)	n/a	4
Annual coupon	6.00%	6.00%
Interest payment	Semiannual	Semiannual
Yield to maturity	6.0542%	6.4227%

Rogers obtained the prices shown in Exhibit 1 using software that generates an interest rate lattice. He uses his software to generate the interest rate lattice shown in Exhibit 2.

Exhibit 2: Interest Rate Lattice (Annualized Interest Rates)

								15.44%
							14.10%	
						12.69%		12.46%
					11.85%		11.38%	
				9.75%		10.25%		10.05%
			8.95%		9.57%		9.19%	
		7.91%		7.88%		8.28%		8.11%
	7.35%		7.23%		7.74%		7.42%	
6.62%		6.40%		6.37%		6.69%		6.54%
6.05%	5.95%		5.85%		6.25%		5.99%	
5.36%		5.17%		5.15%		5.40%		5.28%
	4.81%		4.73%		5.05%		4.83%	
		4.18%		4.16%		4.36%		4.26%
			3.82%		4.08%		3.90%	
				3.37%		3.52%		3.44%
					3.30%		3.15%	
						2.84%		2.77%
							2.54%	
								2.24%
Years	0.5	1.0	1.5	2.0	2.5	3.0	3.5	4.0	4.5

.....

The market value of the embedded call option in Exhibit 1 is *closest* to:

A) 1.56.

B) 1.65.

C) 1.79.

Question #52 of 60

Question ID: 691255

William Rogers, a fixed-income portfolio manager, needs to eliminate a large cash position in his portfolio. He would like to purchase some corporate bonds. Two bonds that he is evaluating are shown in Exhibit 1. These two bonds are from the same issuer, and the current call price for the callable bond is 100. Assume that the issuer will call if the bond price exceeds the call price.

Rogers is also concerned about increases in interest rates and is considering the purchase of a putable bond. He wants to determine how assumed increases or decreases in interest rate volatility affect the value of the straight bonds and bonds with embedded options. After Rogers performs some analysis, he and his supervisor, Sigourney Walters, discuss the relative price movement between the two bonds in Exhibit 1 when interest rates change significantly.

During the discussions, Rogers makes the following statements:

Statement 1:	If the volatility of interest rates decreases, the value of the callable bond will increase.
Statement 2:	The noncallable bond will not be affected by a change in the volatility or level of interest rates.
Statement 3:	When interest rates decrease, the value of the noncallable bond increases by more than the callable bond.
Statement 4:	If the volatility of interest rates increases, the value of the putable bond will increase.

Walters mentors Rogers on bond concepts and then asks him to consider the pricing of a third bond. The third bond has five years to maturity, a 6% annual coupon, and pays interest semiannually. The bond is both callable and putable at 100 at any time. Walters indicates that the holders of the bond's embedded options will exercise if the option is in-the-money.

Exhibit 1: Bond Descriptions

	Noncallable Bond	*Callable Bond*
Price	99.77	98.21
Time to maturity (years)	5	5
Time to first call date (years)	n/a	4
Annual coupon	6.00%	6.00%
Interest payment	Semiannual	Semiannual
Yield to maturity	6.0542%	6.4227%

Rogers obtained the prices shown in Exhibit 1 using software that generates an interest rate lattice. He uses his software to generate the interest rate lattice shown in Exhibit 2.

Exhibit 2: Interest Rate Lattice (Annualized Interest Rates)

15.44%

								14.10%	
						12.69%		12.46%	
					11.85%		11.38%		
				9.75%		10.25%		10.05%	
			8.95%		9.57%		9.19%		
		7.91%		7.88%		8.28%		8.11%	
	7.35%		7.23%		7.74%		7.42%		
6.62%		6.40%		6.37%		6.69%		6.54%	
6.05%	5.95%		5.85%		6.25%		5.99%		
5.36%		5.17%		5.15%		5.40%		5.28%	
	4.81%		4.73%		5.05%		4.83%		
		4.18%		4.16%		4.36%		4.26%	
			3.82%		4.08%		3.90%		
				3.37%		3.52%		3.44%	
					3.30%		3.15%		
						2.84%		2.77%	
							2.54%		
								2.24%	
Years	0.5	1.0	1.5	2.0	2.5	3.0	3.5	4.0	4.5

.....

For this question only, ignore the information from Exhibit 1 and any other calculations in other questions. Rather, assume that the interest rate lattice provided in Exhibit 2 is constructed to be arbitrage-free. However, when Rogers calculates the price of the callable bond using the interest rates in the lattice, he gets a value higher than the market price of the bond.
Is the price of the third callable and putable bond *likely* to be less than, equal to, or greater than 100%, and is the option-adjusted spread (OAS) on the callable bond *likely* to be zero, positive, or negative?

	Price of third bond	OAS of callable bond
A)	Less than 100%	Zero
B)	Equal to 100%	Positive
C)	Greater than 100%	Negative

Question #53 of 60

Question ID: 691251

William Rogers, a fixed-income portfolio manager, needs to eliminate a large cash position in his portfolio. He would like to purchase some corporate bonds. Two bonds that he is evaluating are shown in Exhibit 1. These two bonds are from the same issuer, and the current call price for the callable bond is 100. Assume that the issuer will call if the bond price exceeds the call

issuer, and the current call price for the callable bond is 100. Assume that the issuer will call if the bond price exceeds the call price.

Rogers is also concerned about increases in interest rates and is considering the purchase of a putable bond. He wants to determine how assumed increases or decreases in interest rate volatility affect the value of the straight bonds and bonds with embedded options. After Rogers performs some analysis, he and his supervisor, Sigourney Walters, discuss the relative price movement between the two bonds in Exhibit 1 when interest rates change significantly.

During the discussions, Rogers makes the following statements:

Statement 1:	If the volatility of interest rates decreases, the value of the callable bond will increase.
Statement 2:	The noncallable bond will not be affected by a change in the volatility or level of interest rates.
Statement 3:	When interest rates decrease, the value of the noncallable bond increases by more than the callable bond.
Statement 4:	If the volatility of interest rates increases, the value of the putable bond will increase.

Walters mentors Rogers on bond concepts and then asks him to consider the pricing of a third bond. The third bond has five years to maturity, a 6% annual coupon, and pays interest semiannually. The bond is both callable and putable at 100 at any time. Walters indicates that the holders of the bond's embedded options will exercise if the option is in-the-money.

Exhibit 1: Bond Descriptions

	Noncallable Bond	*Callable Bond*
Price	99.77	98.21
Time to maturity (years)	5	5
Time to first call date (years)	n/a	4
Annual coupon	6.00%	6.00%
Interest payment	Semiannual	Semiannual
Yield to maturity	6.0542%	6.4227%

Rogers obtained the prices shown in Exhibit 1 using software that generates an interest rate lattice. He uses his software to generate the interest rate lattice shown in Exhibit 2.

Exhibit 2: Interest Rate Lattice (Annualized Interest Rates)

				15.44%
			14.10%	
		12.69%		12.46%
		11.85%	11.38%	
	9.75%		10.25%	10.05%
	8.95%	9.57%		9.19%
7.91%		7.88%	8.28%	8.11%

		7.35%		7.23%		7.74%		7.42%	
	6.62%		6.40%		6.37%		6.69%		6.54%
6.05%		5.95%		5.85%		6.25%		5.99%	
	5.36%		5.17%		5.15%		5.40%		5.28%
		4.81%		4.73%		5.05%		4.83%	
			4.18%		4.16%		4.36%		4.26%
				3.82%		4.08%		3.90%	
					3.37%		3.52%		3.44%
						3.30%		3.15%	
							2.84%		2.77%
								2.54%	
									2.24%
Years	0.5	1.0	1.5	2.0	2.5	3.0	3.5	4.0	4.5

.....

Using the information in the question and the following relevant portion of the interest rate and pricing trees, Rogers calculates the value of the noncallable bond at node A.

Corresponding portion of the interest rate tree (given as bond-equivalent yields):

		8.95%
	7.91%	
		7.23%
Years	1.5	2.0

Corresponding portion of the binomial price tree:

		91.73%
	A →	
		96.17%
Years	1.5	2.0

The price of the noncallable bond at node A is *closest* to:

A) 89.84% of par.

B) 93.26% of par.

C) 96.14% of par.

Question #54 of 60

Question ID: 691256

William Rogers, a fixed-income portfolio manager, needs to eliminate a large cash position in his portfolio. He would like to purchase some corporate bonds. Two bonds that he is evaluating are shown in Exhibit 1. These two bonds are from the same issuer, and the current call price for the callable bond is 100. Assume that the issuer will call if the bond price exceeds the call price.

Rogers is also concerned about increases in interest rates and is considering the purchase of a putable bond. He wants to determine how assumed increases or decreases in interest rate volatility affect the value of the straight bonds and bonds with embedded options. After Rogers performs some analysis, he and his supervisor, Sigourney Walters, discuss the relative price movement between the two bonds in Exhibit 1 when interest rates change significantly.

During the discussions, Rogers makes the following statements:

Statement 1:	If the volatility of interest rates decreases, the value of the callable bond will increase.
Statement 2:	The noncallable bond will not be affected by a change in the volatility or level of interest rates.
Statement 3:	When interest rates decrease, the value of the noncallable bond increases by more than the callable bond.
Statement 4:	If the volatility of interest rates increases, the value of the putable bond will increase.

Walters mentors Rogers on bond concepts and then asks him to consider the pricing of a third bond. The third bond has five years to maturity, a 6% annual coupon, and pays interest semiannually. The bond is both callable and putable at 100 at any time. Walters indicates that the holders of the bond's embedded options will exercise if the option is in-the-money.

Exhibit 1: Bond Descriptions

	Noncallable Bond	*Callable Bond*
Price	99.77	98.21
Time to maturity (years)	5	5
Time to first call date (years)	n/a	4
Annual coupon	6.00%	6.00%
Interest payment	Semiannual	Semiannual
Yield to maturity	6.0542%	6.4227%

Rogers obtained the prices shown in Exhibit 1 using software that generates an interest rate lattice. He uses his software to generate the interest rate lattice shown in Exhibit 2.

Exhibit 2: Interest Rate Lattice (Annualized Interest Rates)

									15.44%
								14.10%	
							12.69%		12.46%
						11.85%		11.38%	
					9.75%		10.25%		10.05%
				8.95%		9.57%		9.19%	
			7.91%		7.88%		8.28%		8.11%
		7.35%		7.23%		7.74%		7.42%	
	6.62%		6.40%		6.37%		6.69%		6.54%
6.05%		5.95%		5.85%		6.25%		5.99%	
	5.36%		5.17%		5.15%		5.40%		5.28%
		4.81%		4.73%		5.05%		4.83%	
			4.18%		4.16%		4.36%		4.26%
				3.82%		4.08%		3.90%	
					3.37%		3.52%		3.44%
						3.30%		3.15%	
							2.84%		2.77%
								2.54%	
									2.24%
Years	0.5	1.0	1.5	2.0	2.5	3.0	3.5	4.0	4.5

.....

Using the information in the question and the following relevant portion of the interest rate and pricing trees, Rogers calculates the value of the callable bond at node B.

Corresponding portion of the interest rate tree (given as bond-equivalent yields):

		3.44%
	3.15%	
		2.77%
Years	4.0	4.5

Corresponding portion of the callable bond price tree:

	$100.00

	B →	
	$100.00	
Years	4.0	4.5

The price of the callable bond at node B is *closest* to:

A) 100.0% of par.

B) 101.4% of par.

C) 102.5% of par.

Question #55 of 60

Question ID: 691258

Questions 55-60 relate to Ted Thompson.

Ted Thompson, CIO for Aplius Insurance company, is evaluating the credit risk management models for the company's fixed income portfolio. Thompson meets with Nambi Musa, who is the head of Aplius's credit risk analysis department. Musa assures Thompson that his team has updated the credit risk analysis models over recent years and that these updated models have performed well over the past 12 months. Thompson, however, is not pleased with the losses incurred on Aplius's municipal bond holdings in the last quarter.

Musa mentions that while the credit risk analysis department continues to use credit ratings, they are also evaluating other analytical tools including structural models. He specifically mentions present value of expected loss as one credit risk measure currently being used. Musa makes the following statements:

Statement 1:	"One of the strengths of credit ratings is that they tend to be stable over time and hence reduce the price volatility in debt markets."
Statement 2:	"The present value of expected loss on a bond is the maximum amount an investor would be willing to pay to an insurer to bear the credit risk of that security."
Statement 3:	"One of the assumptions of the structural models of credit analysis is that the default risk changes over a business cycle."
Statement 4:	"In case of an ABS, credit analysis focuses on the probability of loss instead of the probability of default."

Musa further discusses the credit analysis metrics that are newly developed. As an example, he illustrates the valuation conducted on 1-year, 5% Zeta Corp. senior unsecured bonds. Exhibit 1 shows the report. Rates are continuously compounded.

Exhibit 1: Valuation of 1-year, 5% Zeta

Corp. Bond

Time to Cash Flow	*Cash Flow*	*Risk-Free Spot Rate (%)*	*Credit Spread (%)*
0.5	25	0.23	0.8
1	1025	0.25	0.85

Thompson then tells Musa that the credit analysis department should focus on reduced form models. Thompson states that, "reduced form models perform better than structural models as they tend to impose assumptions on the outputs of the structural model. However, reduced form models require a specification of the company's balance sheet composition."

.....

Musa's statement 1 is *most likely*:

A) correct.

B) incorrect because credit ratings are unstable over time.

C) incorrect because of the implied relation to price volatility in debt markets.

Question #56 of 60

Question ID: 691257

Ted Thompson, CIO for Aplius Insurance company, is evaluating the credit risk management models for the company's fixed income portfolio. Thompson meets with Nambi Musa, who is the head of Aplius's credit risk analysis department. Musa assures Thompson that his team has updated the credit risk analysis models over recent years and that these updated models have performed well over the past 12 months. Thompson, however, is not pleased with the losses incurred on Aplius's municipal bond holdings in the last quarter.

Musa mentions that while the credit risk analysis department continues to use credit ratings, they are also evaluating other analytical tools including structural models. He specifically mentions present value of expected loss as one credit risk measure currently being used. Musa makes the following statements:

Statement 1:	"One of the strengths of credit ratings is that they tend to be stable over time and hence reduce the price volatility in debt markets."
Statement 2:	"The present value of expected loss on a bond is the maximum amount an investor would be willing to pay to an insurer to bear the credit risk of that security."
Statement 3:	"One of the assumptions of the structural models of credit analysis is that the default risk changes over a business cycle."
Statement 4:	"In case of an ABS, credit analysis focuses on the probability of loss instead of the probability of default."

Musa further discusses the credit analysis metrics that are newly developed. As an example, he illustrates the valuation

Musa further discusses the credit analysis models that are newly developed. As an example, he illustrates the valuation conducted on 1-year, 5% Zeta Corp. senior unsecured bonds. Exhibit 1 shows the report. Rates are continuously compounded.

Exhibit 1: Valuation of 1-year, 5% Zeta Corp. Bond

Time to Cash Flow	*Cash Flow*	*Risk-Free Spot Rate (%)*	*Credit Spread (%)*
0.5	25	0.23	0.8
1	1025	0.25	0.85

Thompson then tells Musa that the credit analysis department should focus on reduced form models. Thompson states that, "reduced form models perform better than structural models as they tend to impose assumptions on the outputs of the structural model. However, reduced form models require a specification of the company's balance sheet composition."

.....

Musa's statement 2 is *most likely*:

A) correct.

B) incorrect as the statement only considers credit risk.

C) incorrect as the statement should refer to expected loss and not to present value of expected loss.

Question #57 of 60

Question ID: 691259

Ted Thompson, CIO for Aplius Insurance company, is evaluating the credit risk management models for the company's fixed income portfolio. Thompson meets with Nambi Musa, who is the head of Aplius's credit risk analysis department. Musa assures Thompson that his team has updated the credit risk analysis models over recent years and that these updated models have performed well over the past 12 months. Thompson, however, is not pleased with the losses incurred on Aplius's municipal bond holdings in the last quarter.

Musa mentions that while the credit risk analysis department continues to use credit ratings, they are also evaluating other analytical tools including structural models. He specifically mentions present value of expected loss as one credit risk measure currently being used. Musa makes the following statements:

Statement 1:	"One of the strengths of credit ratings is that they tend to be stable over time and hence reduce the price volatility in debt markets."
Statement 2:	"The present value of expected loss on a bond is the maximum amount an investor would be willing to pay to an insurer to bear the credit risk of that security."
Statement 3:	"One of the assumptions of the structural models of credit

analysis is that the default risk changes over a business cycle."

Statement 4: "In case of an ABS, credit analysis focuses on the probability of loss instead of the probability of default."

Musa further discusses the credit analysis metrics that are newly developed. As an example, he illustrates the valuation conducted on 1-year, 5% Zeta Corp. senior unsecured bonds. Exhibit 1 shows the report. Rates are continuously compounded.

Exhibit 1: Valuation of 1-year, 5% Zeta Corp. Bond

Time to Cash Flow	*Cash Flow*	*Risk-Free Spot Rate (%)*	*Credit Spread (%)*
0.5	25	0.23	0.8
1	1025	0.25	0.85

Thompson then tells Musa that the credit analysis department should focus on reduced form models. Thompson states that, "reduced form models perform better than structural models as they tend to impose assumptions on the outputs of the structural model. However, reduced form models require a specification of the company's balance sheet composition."

.....

Musa's statement 3 is *most likely*:

A) correct.

B) incorrect as structural models assume that default risk is constant over a business cycle.

C) incorrect as structural models assume that default risk is constant over the life of the bond.

Question #58 of 60

Question ID: 691262

Ted Thompson, CIO for Aplius Insurance company, is evaluating the credit risk management models for the company's fixed income portfolio. Thompson meets with Nambi Musa, who is the head of Aplius's credit risk analysis department. Musa assures Thompson that his team has updated the credit risk analysis models over recent years and that these updated models have performed well over the past 12 months. Thompson, however, is not pleased with the losses incurred on Aplius's municipal bond holdings in the last quarter.

Musa mentions that while the credit risk analysis department continues to use credit ratings, they are also evaluating other analytical tools including structural models. He specifically mentions present value of expected loss as one credit risk measure currently being used. Musa makes the following statements:

Statement 1: "One of the strengths of credit ratings is that they tend to be stable over time and hence reduce the price volatility in debt

markets."

Statement 2: "The present value of expected loss on a bond is the maximum amount an investor would be willing to pay to an insurer to bear the credit risk of that security."

Statement 3: "One of the assumptions of the structural models of credit analysis is that the default risk changes over a business cycle."

Statement 4: "In case of an ABS, credit analysis focuses on the probability of loss instead of the probability of default."

Musa further discusses the credit analysis metrics that are newly developed. As an example, he illustrates the valuation conducted on 1-year, 5% Zeta Corp. senior unsecured bonds. Exhibit 1 shows the report. Rates are continuously compounded.

Exhibit 1: Valuation of 1-year, 5% Zeta Corp. Bond

Time to Cash Flow	*Cash Flow*	*Risk-Free Spot Rate (%)*	*Credit Spread (%)*
0.5	25	0.23	0.8
1	1025	0.25	0.85

Thompson then tells Musa that the credit analysis department should focus on reduced form models. Thompson states that, "reduced form models perform better than structural models as they tend to impose assumptions on the outputs of the structural model. However, reduced form models require a specification of the company's balance sheet composition."

.....

Musa's statement 4 is *most likely*:

A) correct.

B) incorrect as credit analysis of ABS focuses on the probability of default instead of the probability of loss.

C) incorrect as credit analysis of ABS focuses on probability of tranche default instead of probability of default.

Question #59 of 60

Question ID: 692305

Ted Thompson, CIO for Aplius Insurance company, is evaluating the credit risk management models for the company's fixed income portfolio. Thompson meets with Nambi Musa, who is the head of Aplius's credit risk analysis department. Musa assures Thompson that his team has updated the credit risk analysis models over recent years and that these updated models have performed well over the past 12 months. Thompson, however, is not pleased with the losses incurred on Aplius's municipal bond holdings in the last quarter.

Musa mentions that while the credit risk analysis department continues to use credit ratings, they are also evaluating other analytical tools including structural models. He specifically mentions present value of expected loss as one credit risk measure currently being used. Musa makes the following statements:

Statement 1:	"One of the strengths of credit ratings is that they tend to be stable over time and hence reduce the price volatility in debt markets."
Statement 2:	"The present value of expected loss on a bond is the maximum amount an investor would be willing to pay to an insurer to bear the credit risk of that security."
Statement 3:	"One of the assumptions of the structural models of credit analysis is that the default risk changes over a business cycle."
Statement 4:	"In case of an ABS, credit analysis focuses on the probability of loss instead of the probability of default."

Musa further discusses the credit analysis metrics that are newly developed. As an example, he illustrates the valuation conducted on 1-year, 5% Zeta Corp. senior unsecured bonds. Exhibit 1 shows the report. Rates are continuously compounded.

Exhibit 1: Valuation of 1-year, 5% Zeta Corp. Bond

Time to Cash Flow	*Cash Flow*	*Risk-Free Spot Rate (%)*	*Credit Spread (%)*
0.5	25	0.23	0.8
1	1025	0.25	0.85

Thompson then tells Musa that the credit analysis department should focus on reduced form models. Thompson states that, "reduced form models perform better than structural models as they tend to impose assumptions on the outputs of the structural model. However, reduced form models require a specification of the company's balance sheet composition."

.....

Using information in Exhibit 1, the present value of expected loss for the Zeta Corp. bond is *closest* to:

A) $7.74.

B) $8.25.

C) $8.76.

Question #60 of 60

Question ID: 691260

Ted Thompson, CIO for Aplius Insurance company, is evaluating the credit risk management models for the company's fixed

Tod Thompson, CFO for Aplius Insurance Company, is evaluating the credit risk management models for the company's fixed income portfolio. Thompson meets with Nambi Musa, who is the head of Aplius's credit risk analysis department. Musa assures Thompson that his team has updated the credit risk analysis models over recent years and that these updated models have performed well over the past 12 months. Thompson, however, is not pleased with the losses incurred on Aplius's municipal bond holdings in the last quarter.

Musa mentions that while the credit risk analysis department continues to use credit ratings, they are also evaluating other analytical tools including structural models. He specifically mentions present value of expected loss as one credit risk measure currently being used. Musa makes the following statements:

Statement 1:	"One of the strengths of credit ratings is that they tend to be stable over time and hence reduce the price volatility in debt markets."
Statement 2:	"The present value of expected loss on a bond is the maximum amount an investor would be willing to pay to an insurer to bear the credit risk of that security."
Statement 3:	"One of the assumptions of the structural models of credit analysis is that the default risk changes over a business cycle."
Statement 4:	"In case of an ABS, credit analysis focuses on the probability of loss instead of the probability of default."

Musa further discusses the credit analysis metrics that are newly developed. As an example, he illustrates the valuation conducted on 1-year, 5% Zeta Corp. senior unsecured bonds. Exhibit 1 shows the report. Rates are continuously compounded.

Exhibit 1: Valuation of 1-year, 5% Zeta Corp. Bond

Time to Cash Flow	*Cash Flow*	*Risk-Free Spot Rate (%)*	*Credit Spread (%)*
0.5	25	0.23	0.8
1	1025	0.25	0.85

Thompson then tells Musa that the credit analysis department should focus on reduced form models. Thompson states that, "reduced form models perform better than structural models as they tend to impose assumptions on the outputs of the structural model. However, reduced form models require a specification of the company's balance sheet composition."

.....

Thompson's statement about reduced form models relative to structural model is *most likely*:

A) correct.

B) incorrect regarding assumptions imposed.

C) incorrect regarding specification of balance sheet composition being required.